SCOTT P. COOPER, SBN 96905
scooper@proskauer.com
KEITH BUTLER, SBN 215670
kbutler@proskauer.com
PROSKAUER ROSE LLP
2049 Century Park East, 32nd Floor
Los Angeles, California 90067-3206
Telephone: (310) 557-2900
Facsimile: (310) 557-2193

Attorneys for Defendant
MBIA, INC.

ORIGINAL FILED
SEP 22 2008
RICHARD W. WIEKING
CLERK, U.S. DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

E-filing

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

MEJ

CITY OF OAKLAND, Plaintiff, v. AMBAC FINANCIAL GROUP INC.; MBIA, INC.; XL CAPITAL ASSURANCE INC.; FINANCIAL GUARANTY INSURANCE COMPANY; CIFG ASSURANCE NORTH AMERICA, INC.; JASON KISSANE; NEIL PACK; and Does 1 – 50, Defendants.	Case No. CV 08 4425 **NOTICE OF REMOVAL OF CIVIL ACTION FROM THE SUPERIOR COURT OF THE STATE OF CALIFORNIA FOR THE COUNTY OF SAN FRANCISCO; DECLARATION OF SCOTT COOPER IN SUPPORT THEREOF** (S.F. Superior Court, Case No. CGC-08-479241) **[No Hearing Required]**

TO THE CLERK OF THE ABOVE-ENTITLED COURT:

PLEASE TAKE NOTICE that defendant MBIA, Inc. ("MBIA"), pursuant to 28 U.S.C. §§ 1332, 1441, and 1446, gives notice that the above-captioned matter is hereby removed to the United States District Court for the Northern District of California from the Superior Court of California, County of San Francisco, where it originally was filed as Case No. CGC-08-479241 on August 28, 2008.

I. THIS NOTICE OF REMOVAL IS TIMELY AND PROPERLY FILED

1. Plaintiff filed the complaint in this matter in the Superior Court of California in and for the County of San Francisco on or about August 28, 2008. (Declaration of Scott P. Cooper ("Cooper Decl.") at ¶ 2.)

2. The date upon which defendant MBIA was served with a copy of the Summons and Complaint was on or around September 12, 2008. (Cooper Decl. at ¶ 2.) A copy of the Summons and Complaint is attached as Exhibit A to the accompanying Cooper Declaration.

3. Pursuant to 28 U.S.C. § 1446(a), Exhibit A constitutes the only process, pleadings, and orders served upon MBIA in this case.

4. Pursuant to 28 U.S.C. § 1446(b), MBIA is filing this Notice of Removal within thirty (30) days of service on it of the Summons and Complaint. Moreover, MBIA is filing this Notice of Removal within thirty days of service of the Summons and Complaint on any other party in this action. *See Murphy Bros., Inc. v. Michetti Pipe Stringing, Inc.*, 526 U.S. 344, 354, 119 S. Ct. 1322, 1328, 143 L.Ed. 2d 448 (1999) (holding that time for removal does not begin to run prior to service of process); *Luchetti v. Hershey Co.*, No. 08-1629, 2008 WL 2331965, at *3 (N.D. Cal. June 4, 2008) (finding formal service of process "a prerequisite for triggering the 30-day removal period").

5. Venue is proper under 28 U.S.C. § 1441(a), which provides for removal to the district court of the United States for the district and division embracing the place where the action is pending.

6. Notice of this removal is being given both to the adverse party and to the state court pursuant to 28 U.S.C. § 1446(d). A true and correct copy of the Notice to Adverse Party is attached hereto as Exhibit B to the Cooper Declaration. A true and correct copy of the Notice to State Court is attached hereto as Exhibit C to the Cooper Declaration.

7. Additionally, Plaintiff's counsel in this matter filed nearly identical complaints on July 23, 2008 on behalf of the City of Los Angeles in the Superior Court of California in and for the County of Los Angeles, entitled City of Los Angeles v. Ambac Financial Group Inc. *et al.*, under Docket No. BC394943, and on behalf of the City of Stockton in the Superior Court of California in and for the County of San Francisco, entitled City of Stockton v. Ambac Financial Group Inc. et al., as Case No. CGC-08-477848. On August 22, 2008, the Los Angeles action was removed to federal district court for the Central District of California, and the Stockton action was removed to federal district court for the Northern District of California.

II. INTRADISTRICT ASSIGNMENT

8. Because Plaintiff alleges that its "claims arise directly from business conducted in the City and County of San Francsico" (Complaint at ¶ 24), and because Plaintiff initially commenced the Action in the Superior Court of the State of California for the County of San Francisco, pursuant to 28 U.S.C. § 84(a) and Civil Local Rule 3-5(b), the Action once removed is properly assigned to the San Francisco Division of the United States District Court for the Northern District of California.

III. BASIS OF REMOVAL

9. The Court has original jurisdiction over this civil action under 28 U.S.C. § 1332 because there is complete diversity of citizenship between the properly-joined parties.

10. Plaintiff City of Oakland ("Plaintiff") is a California public entity. (Complaint at ¶ 25)

11. Defendant Ambac Financial Group Inc. is a Delaware corporation with its principal place of business in New York, New York. (Complaint at ¶ 26)

12. Defendant MBIA Inc. is a Connecticut corporation with its principal place of business in Armonk, New York. (Complaint at ¶ 27)

13. Defendant XL Capital Assurance Inc. is a New York corporation with its principal place of business in New York, New York. (Complaint at ¶ 28)

14. Defendant Financial Guaranty Insurance Company is a New York corporation with its principal place of business in New York, New York. (Complaint at ¶ 29)

15. Defendant CIFG Assurance North America, Inc. is a New York stock insurance company with its principal place of business in New York. (Complaint at ¶ 30)

16. Accordingly, none of these defendants (the "Bond Insurers") are citizens or residents of California.

17. Although the Complaint does not attempt to quantify the alleged damages, it is clear from the Complaint that the amount in controversy easily exceeds $75,000 as required by 28 U.S.C. § 1332(b). For example, the Complaint states that California public entities paid "hundreds of millions of dollars" in premiums for bond insurance that the Complaint alleges was "worthless." (Complaint at ¶ 2) Plaintiff also seeks punitive and exemplary damages (Complaint at ¶ E), which are included in the calculation of the amount in controversy. *See Bell v. Preferred Life Assur. Soc.*, 320 U.S. 238, 240, 64 S. Ct. 5, 6, 88 L.Ed. 15 (1943).

IV. DEFENDANTS JASON KISSANE AND NEIL PACK HAVE BEEN FRAUDULENTLY JOINED

18. In addition to the Bond Insurers, Plaintiff has named as defendants two individuals, Jason Kissane and Neil Pack, who are alleged to be California citizens,

for the sole purpose of destroying complete diversity and preventing defendants from removing this case to federal court.

19. Aside from their statuses as current and/or former employees of certain of the defendants, Kissane and Pack have no connection to the alleged activities that lie at the core of this case, and they are not the subject of any specific allegations of conduct that would be sufficient to state a claim against either of them. Given the limited roles of these two individuals in the matters about which Plaintiff complains, there is no possibility that Plaintiff can state a cause of action against either of them.

20. Accordingly, Kissane and Pack were fraudulently joined and they should be disregarded in determining the presence of diversity jurisdiction. It is well-established law that fraudulently joined resident defendants will not defeat a defendant's right of removal on diversity grounds. *Wilson v. Republic Iron & Steel Co.*, 257 U.S. 92, 97, 42 S. Ct. 35, 37, 66 L.Ed. 144 (1921); *Ritchey v. Upjohn Drug Co.*, 139 F.3d 1313, 1318 (9th Cir. 1998). Joinder is fraudulent if "the plaintiff fails to state a cause of action against a resident defendant, and the failure is obvious according to the settled rules of the state." *McCabe v. Gen. Foods Corp.*, 811 F.2d 1336, 1339 (9th Cir. 1987).

21. Only the Fourth and Sixth causes of action – negligent misrepresentation and violation of the Cartwright Act – are brought against Kissane and Pack, and the Complaint, which mentions Pack and Kissane specifically in only five paragraphs (Complaint at ¶¶ 24, 31, 32, 184, 185), falls far short of stating those claims.

22. With respect to the negligent misrepresentation claim, the essential elements are: "(1) a false statement of a material fact that the defendant honestly believes to be true, but made without reasonable grounds for such belief, (2) made with the intent to induce reliance, (3) reasonable reliance on the statement, and (4) damages." *Century Sur. Co. v. Crosby Ins., Inc.*, 124 Cal. App. 4th 116, 129, 21 Cal. Rptr. 3d 115, 125 (2004). A claim of negligent misrepresentation under California

law "must be pleaded with particularity and by facts that show how, when, where, to whom, and by what means the representations were tendered." *Charnay v. Cobert*, 145 Cal. App. 4th 170, 185 n.14, 51 Cal. Rptr. 3d 471, 482 n.14 (2006) (internal quotations omitted); *see also Cadlo v. Owens-Illinois, Inc.*, 125 Cal. App. 4th 513, 519, 23 Cal. Rptr. 3d 1, 5 (2004) ("The policy of liberal construction of pleadings is not generally invoked to sustain a misrepresentation pleading defective in any material respect."). The Complaint fails to allege a single statement made by Kissane or Pack, to Plaintiff or anyone else, much less a false statement of a material fact, honestly believed to be true, but made without reasonable grounds for such belief and with the intent to induce reliance. Furthermore, to the extent that Plaintiff bases its claim on alleged omissions in financial statements and other public disclosures made by the Bond Insurers, Kissane and Pack played absolutely no roles in making those statements and owed no independent duty to Plaintiff with respect to those disclosures.

23. The Complaint also plainly fails to state a claim for violation of the Cartwright Act, Cal. Bus. & Prof. Code § 16720 *et seq*. against Pack and Kissane. Settled California law requires that to state a claim for a conspiracy in restraint of trade, a complaint must allege "(1) the formation and operation of the conspiracy, (2) the wrongful act or acts done pursuant thereto, and (3) the damage resulting from such act or acts." *Chicago Title Ins. Co. v. Great W. Fin. Corp.*, 69 Cal.2d 305, 316, 70 Cal. Rptr. 849, 856 (1968). "California requires a 'high degree of particularity' in the pleading of Cartwright Act violations, ... and therefore generalized allegations of antitrust violations are usually insufficient." *Freeman v. San Diego Ass'n of Realtors*, 77 Cal. App. 4th 171, 196, 91 Cal. Rptr. 2d 534, 553 (2000) (*quoting Motors, Inc. v. Times Mirror Co.*, 102 Cal. App. 3d 735, 742, 162 Cal. Rptr. 543, 547 (1980)). Moreover, under the pleading standard established in *Bell Atl. Corp. v. Twombly*, __U.S.__, 127 S.Ct. 1955,167 L.Ed.2d 929 (2007), the "[f]actual allegations must be enough to raise a right to relief above the speculative

level." *Id.* at 1964-65. A complaint must allege "enough facts to state a claim to relief that is plausible on its face." *Id.* at 1974. *See also In re Late Fee and Over-Limit Fee Litigation*, 528 F. Supp. 2d 953, 965 (N.D. Cal. 2007) (applying *Twombly*'s pleading standard in dismissing Cartwright Act claim on grounds that "analysis under California's antitrust law mirrors the analysis under federal law"); *Korea Kumho Petrochemical v. Flexsys Am.*, No. C07-01057, 2008 WL 686834 at *8 (N.D. Cal. Mar. 11, 2008) (same, stating that "California state courts follow federal cases in deciding claims under the Cartwright Act").

24. With respect to Kissane and Pack, the Complaint simply alleges, in conclusory fashion, that they "knew and acted in concert with other Defendants to maintain the dual rating system." Such general allegations are not sufficient to state a claim unless "the unlawful acts or civil wrongs are otherwise sufficiently alleged." *Chicago Title Ins.*, 69 Cal.2d at 316, 70 Cal. Rptr. at 856. The only act that the Complaint alleges with respect to Kissane and Pack is their attendance of two industry conferences, where it is alleged that the topics of "the municipal bond insurance industry" and "how to maintain the bond insurance industry by perpetuating the dual rating system" were discussed. (Complaint at ¶ 184, 185) This allegation clearly does not sufficiently allege any unlawful acts or civil wrongs.

25. Moreover, Pack and Kissane are not individually liable for any alleged wrongful acts of their employers because they themselves were not personally involved in those acts. See Cal. Civ. Code § 2343. Although the doctrine of *respondeat superior* may make a corporation liable for the acts of its employees, the reverse does not hold true – an employee is not generally individually liable for the wrongful acts of its employer corporation.

26. For the reasons set forth above, there is no reasonable basis to argue that California law could impose individual liability on Kissane or Pack for negligent misrepresentation or violations of the Cartwright Act. There are no facts pled in the Complaint to support a claim that Kissane or Pack engaged in the alleged

unlawful activities, nor could such facts be pled in an amended complaint. Both Kissane and Pack worked in public finance departments. They had little to no interaction with their companies' structured finance departments, and they had no responsibility for or involvement in preparation of their companies' financial statements or other public disclosures. They also had little interaction with the rating agencies, which consisted of occasional communications about analyses of particular municipal bond issues, and they certainly never had any discussions about the ratings agencies' bond rating standards or processes, much less the ability to dictate to the ratings agencies any aspects of them. Kissane's and Pack's attendance at industry conferences, along with hundreds of individuals representing issuers, insurers, investment bankers, and financial advisers, is not indicative of any wrongdoing. The fraudulent joinder of Kissane and Pack, who have "no real connection with the controversy," cannot defeat the defendants' right of removal. *Wilson*, 257 U.S. at 97, 42 S. Ct. at 37.

V. DOE DEFENDANTS DO NOT DEFEAT REMOVAL

27. The Doe defendants should be disregarded in determining the presence of diversity jurisdiction because the Complaint does not identify who they are, where they live, or their relationship to this case. *McCabe*, 811 F.2d at 1339.

VI. CONSENTS TO REMOVAL

28. All defendants other than the improperly-joined Kissane and Pack have joined in this Notice of Removal, as evidenced by the Consents to Removal attached as Exhibit D to the Cooper Declaration. *Emrich v. Touche Ross & Co.*, 846 F.2d 1190, 1193 n.1 (9th Cir. 1988) ("[U]nder 28 U.S.C. § 1446(a), all defendants in a state action must join in the petition for removal, except for nominal, unknown or fraudulently joined parties.")

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29. WHEREFORE, MBIA respectfully requests that the above-captioned action be removed from the Superior Court of California for the County of San Francisco to this Court.

DATED: September 22, 2008

SCOTT P. COOPER
KEITH BUTLER
PROSKAUER ROSE LLP

By: ______________________
Scott P. Cooper
Attorneys for Defendants
MBIA, INC.

7583/53559-017
Current/1199155

DECLARATION OF SCOTT P. COOPER

I, Scott P. Cooper, declare that the foregoing is true and correct to the best of my knowledge and belief :

1. I am an attorney with the law firm of Proskauer Rose LLP, attorneys of record for MBIA, INC ("MBIA"). I am admitted to practice before this Court, and am one of the attorneys responsible for the defense in this case. Except as may be expressly noted below, I have personal knowledge of the facts set forth herein.

2. I am informed and believe that the Complaint and Summons were filed in the San Francisco County Superior Court on August 28, 2008. I am informed and believe that on September 16, 2008, my office received by mail the summons and complaint in this action. Included with the summons and complaint was a Request For Acknowledgement Of Receipt indicating that the summons and complaint were mailed on September 12, 2008. Pursuant to California Code of Civil Procedure section 1013(a), the earliest date on which service could have been effective is September 12, 2008. A true and correct copy of the Complaint that was served on MBIA is attached hereto as Exhibit A.

3. Attached hereto as Exhibit B is a true and correct copy of the Notice to State Court, which will be filed and served following the filing of this Notice of Removal.

4. Attached hereto as Exhibit C is a true and correct copy of the Notice to Adverse Party, which will be filed and served following the filing of this Notice of Removal.

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5. Attached hereto as Exhibit D are true and correct copies of Consents to Removal from all defendants other than Mr. Pack and Mr. Kissane.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct, and that this declaration was executed this 22nd day of September, 2008, at Los Angeles, California.

Scott P. Cooper

EXHIBIT A

SUMMONS
(CITACIÓN JUDICIAL)

SUM-100

FOR COURT USE ONLY
(SOLO PARA USO DE LA CORTE)

NOTICE TO DEFENDANT:
(AVISO AL DEMANDADO):
AMBAC Financial Group Inc.; MBIA Inc.;XL Capital Assurance Inc.;Financial Guaranty Insurance Company;CIFG Assurance North America, Inc.;Jason Kissane;Neil Pack; and Does 1-50

YOU ARE BEING SUED BY PLAINTIFF:
(LO ESTÁ DEMANDANDO EL DEMANDANTE):
City of Oakland

You have 30 CALENDAR DAYS after this summons and legal papers are served on you to file a written response at this court and have a copy served on the plaintiff. A letter or phone call will not protect you. Your written response must be in proper legal form if you want the court to hear your case. There may be a court form that you can use for your response. You can find these court forms and more information at the California Courts Online Self-Help Center (www.courtinfo.ca.gov/selfhelp), your county law library, or the courthouse nearest you. If you cannot pay the filing fee, ask the court clerk for a fee waiver form. If you do not file your response on time, you may lose the case by default, and your wages, money, and property may be taken without further warning from the court.

There are other legal requirements. You may want to call an attorney right away. If you do not know an attorney, you may want to call an attorney referral service. If you cannot afford an attorney, you may be eligible for free legal services from a nonprofit legal services program. You can locate these nonprofit groups at the California Legal Services Web site (www.lawhelpcalifornia.org), the California Courts Online Self-Help Center (www.courtinfo.ca.gov/selfhelp), or by contacting your local court or county bar association.

Tiene 30 DÍAS DE CALENDARIO después de que le entreguen esta citación y papeles legales para presentar una respuesta por escrito en esta corte y hacer que se entregue una copia al demandante. Una carta o una llamada telefónica no lo protegen. Su respuesta por escrito tiene que estar en formato legal correcto si desea que procesen su caso en la corte. Es posible que haya un formulario que usted pueda usar para su respuesta. Puede encontrar estos formularios de la corte y más información en el Centro de Ayuda de las Cortes de California (www.courtinfo.ca.gov/selfhelp/espanol/), en la biblioteca de leyes de su condado o en la corte que le quede más cerca. Si no puede pagar la cuota de presentación, pida al secretario de la corte que le dé un formulario de exención de pago de cuotas. Si no presenta su respuesta a tiempo, puede perder el caso por incumplimiento y la corte le podrá quitar su sueldo, dinero y bienes sin más advertencia.

Hay otros requisitos legales. Es recomendable que llame a un abogado inmediatamente. Si no conoce a un abogado, puede llamar a un servicio de remisión a abogados. Si no puede pagar a un abogado, es posible que cumpla con los requisitos para obtener servicios legales gratuitos de un programa de servicios legales sin fines de lucro. Puede encontrar estos grupos sin fines de lucro en el sitio web de California Legal Services, (www.lawhelpcalifornia.org), en el Centro de Ayuda de las Cortes de California, (www.courtinfo.ca.gov/selfhelp/espanol/) o poniéndose en contacto con la corte o el colegio de abogados locales.

The name and address of the court is:
(El nombre y dirección de la corte es):
Superior Court of California
400 McAllister Street

San Francisco 94102
Civic Center Courthouse

CASE NUMBER: *(Número del Caso):* CGC-08-479241

The name, address, and telephone number of plaintiff's attorney, or plaintiff without an attorney, is:
(El nombre, la dirección y el número de teléfono del abogado del demandante, o del demandante que no tiene abogado, es):
Nanci E. Nishimura (152621) (650) 697-0577
Cotchett, Pitre & McCarthy
840 Malcolm Road
Burlingame, CA 94010

DATE: August 28, 2008 *(Fecha)* GORDON PARK-LI Clerk, by *(Secretario)* ______, Deputy *(Adjunto)*

(For proof of service of this summons, use Proof of Service of Summons *(form POS-010).)*
(Para prueba de entrega de esta citatión use el formulario Proof of Service of Summons, *(POS-010)).*

[SEAL]

NOTICE TO THE PERSON SERVED: You are served
1. ☐ as an individual defendant.
2. ☐ as the person sued under the fictitious name of *(specify)*:
3. ☐ on behalf of *(specify)*:

under: ☐ CCP 416.10 (corporation) ☐ CCP 416.60 (minor)
☐ CCP 416.20 (defunct corporation) ☐ CCP 416.70 (conservatee)
☐ CCP 416.40 (association or partnership) ☐ CCP 416.90 (authorized person)
☐ other *(specify)*:

4. ☐ by personal delivery on *(date)*:

CM-010

ATTORNEY OR PARTY WITHOUT ATTORNEY (Name, State Bar number, and address):
Nanci E. Nishimura (152621)
Cotchett, Pitre & McCarthy
840 Malcolm Road

Burlingame, CA 94010
TELEPHONE NO.: (650) 697-6000 FAX NO.: (650) 697-0577
ATTORNEY FOR (Name): City of Oakland

FOR COURT USE ONLY

FILED
Superior Court of California
County of San Francisco
AUG 2 8 2008
GORDON PARK-LI, Clerk
BY: Deputy Clerk

SUPERIOR COURT OF CALIFORNIA, COUNTY OF San Francisco
STREET ADDRESS: 400 McAllister Street
MAILING ADDRESS:
CITY AND ZIP CODE: San Francisco 94102
BRANCH NAME: Civic Center Courthouse

CASE NAME: City of Oakland v. Ambac Financial Group Inc., et al.

CIVIL CASE COVER SHEET

[X] Unlimited (Amount demanded exceeds $25,000) [ ] Limited (Amount demanded is $25,000 or less)

Complex Case Designation
[ ] Counter [ ] Joinder
Filed with first appearance by defendant (Cal. Rules of Court, rule 3.402)

CASE NUMBER: CGC-08-479241
JUDGE:
DEPT:

Items 1-6 below must be completed (see instructions on page 2).

1. Check one box below for the case type that best describes this case:

Auto Tort
- [ ] Auto (22)
- [ ] Uninsured motorist (46)

Other PI/PD/WD (Personal Injury/Property Damage/Wrongful Death) Tort
- [ ] Asbestos (04)
- [ ] Product liability (24)
- [ ] Medical malpractice (45)
- [ ] Other PI/PD/WD (23)

Non-PI/PD/WD (Other) Tort
- [X] Business tort/unfair business practice (07)
- [ ] Civil rights (08)
- [ ] Defamation (13)
- [ ] Fraud (16)
- [ ] Intellectual property (19)
- [ ] Professional negligence (25)
- [ ] Other non-PI/PD/WD tort (35)

Employment
- [ ] Wrongful termination (36)
- [ ] Other employment (15)

Contract
- [ ] Breach of contract/warranty (06)
- [ ] Rule 3.740 collections (09)
- [ ] Other collections (09)
- [ ] Insurance coverage (18)
- [ ] Other contract (37)

Real Property
- [ ] Eminent domain/Inverse condemnation (14)
- [ ] Wrongful eviction (33)
- [ ] Other real property (26)

Unlawful Detainer
- [ ] Commercial (31)
- [ ] Residential (32)
- [ ] Drugs (38)

Judicial Review
- [ ] Asset forfeiture (05)
- [ ] Petition re: arbitration award (11)
- [ ] Writ of mandate (02)
- [ ] Other judicial review (39)

Provisionally Complex Civil Litigation (Cal. Rules of Court, rules 3.400-3.403)
- [ ] Antitrust/Trade regulation (03)
- [ ] Construction defect (10)
- [ ] Mass tort (40)
- [ ] Securities litigation (28)
- [ ] Environmental/Toxic tort (30)
- [ ] Insurance coverage claims arising from the above listed provisionally complex case types (41)

Enforcement of Judgment
- [ ] Enforcement of judgment (20)

Miscellaneous Civil Complaint
- [ ] RICO (27)
- [ ] Other complaint (*not specified above*) (42)

Miscellaneous Civil Petition
- [ ] Partnership and corporate governance (21)
- [ ] Other petition (*not specified above*) (43)

2. This case [X] is [ ] is not complex under rule 3.400 of the California Rules of Court. If the case is complex, mark the factors requiring exceptional judicial management:
   a. [X] Large number of separately represented parties
   b. [ ] Extensive motion practice raising difficult or novel issues that will be time-consuming to resolve
   c. [X] Substantial amount of documentary evidence
   d. [X] Large number of witnesses
   e. [ ] Coordination with related actions pending in one or more courts in other counties, states, or countries, or in a federal court
   f. [ ] Substantial postjudgment judicial supervision
3. Remedies sought (*check all that apply*): a. [X] monetary b. [X] nonmonetary; declaratory or injunctive relief c. [X] punitive
4. Number of causes of action (*specify*):
5. This case [ ] is [X] is not a class action suit.
6. If there are any known related cases, file and serve a notice of related case. (*You may use form CM-015.*)

Date: August 28, 2008
Nanci E. Nishimura (152621)
(TYPE OR PRINT NAME)

(SIGNATURE OF PARTY OR ATTORNEY FOR PARTY)

NOTICE

- Plaintiff must file this cover sheet with the first paper filed in the action or proceeding (except small claims cases or cases filed under the Probate Code, Family Code, or Welfare and Institutions Code). (Cal. Rules of Court, rule 3.220.) Failure to file may result in sanctions.
- File this cover sheet in addition to any cover sheet required by local court rule.
- If this case is complex under rule 3.400 et seq. of the California Rules of Court, you must serve a copy of this cover sheet on all other parties to the action or proceeding.
- Unless this is a collections case under rule 3.740 or a complex case, this cover sheet will be used for statistical purposes only.

John A. Russo, City Attorney (#129729)
jrusso@oaklandcityattorney.org
Barbara Parker, Chief Asst. City Attorney (#69722)
bparker@oaklandcityattorney.org
Mark Morodomi, Sup. Dep. City Attorney (#120914)
mmorodomi@oaklandcityattorney.org
Kathleen Salem-Boyd, Dep. City Attorney (#160672)
ksalemboyd@oaklandcityattorney.org
CITY OF OAKLAND, CALIFORNIA
One Frank H. Ogawa Plaza, 6th Floor
Oakland, CA 94612
Telephone: (510) 238-3034
Facsimile: (510) 238-6500

Exempt from filing and motion fees pursuant to Gov't Code § 6103

FILED
Superior Court of California
County of San Francisco
AUG 28 2008
GORDON PARK-LI, Clerk
BY: Deputy Clerk

CASE MANAGEMENT CONFERENCE SET
JAN 30 2009 - 9 AM
DEPARTMENT 212

Joseph W. Cotchett (#36324)
jcotchett@cpmlegal.com
Steven N. Williams (#175489)
swilliams@cpmlegal.com
Nanci E. Nishimura (#152621)
nnishimura@cpmlegal.com
COTCHETT, PITRE & McCARTHY
San Francisco Airport Office Center
840 Malcolm Road, Suite 200
Burlingame, CA 94010
Telephone: (650) 697-6000
Facsimile: (650) 697-0577

Louise H. Renne (#36508)
lrenne@rshslaw.com
Steven P. Shaw (#242593)
sshaw@rshslaw.com
RENNE SLOAN HOLTZMAN & SAKAI LLP
350 Sansome St., #300
San Francisco, CA 94104
Telephone: (415) 678-3805
Facsimile: (415) 678-3838

Attorneys for Plaintiff City of Oakland

SUPERIOR COURT OF THE STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF SAN FRANCISCO

CITY OF OAKLAND Plaintiff, vs. AMBAC FINANCIAL GROUP INC.; MBIA INC.; XL CAPITAL ASSURANCE INC.; FINANCIAL GUARANTY INSURANCE COMPANY; CIFG ASSURANCE NORTH AMERICA, INC.; JASON KISSANE;	Case No. CGC 08-479241 COMPLAINT FOR: (1) BREACH OF THE COVENANT OF GOOD FAITH AND FAIR DEALING; (2) FRAUD AND DECEIT; (3) BREACH OF CONTRACT; (4) NEGLIGENT MISREPRESENTATION; (5) NEGLIGENCE; and (6) VIOLATIONS OF CARTWRIGHT ACT (CAL. BUS. & PROF. CODE §§ 16720 *et. seq.*); JURY TRIAL DEMANDED

LAW OFFICES
COTCHETT, PITRE & McCARTHY

NEIL PACK;

and

DOES 1 - 50.

Defendants.

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LAW OFFICES
COTCHETT, PITRE & McCARTHY

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Plaintiff City of Oakland (hereinafter referred to as "Oakland"), hereby brings this action for damages and relief against the Defendants (defined *infra)* for violations of California state common law and for violations of the California Cartwright Act (Cal. Bus. & Prof. Code §§ 16720, *et. seq.*). Plaintiff complains and alleges upon information and belief except as to those paragraphs applicable to the Plaintiff, which are based on personal knowledge, as follows:

I.

INTRODUCTION

1. This case involves the municipal bond insurance industry used by California municipalities to assist in the funding of public projects. California public entities spent hundreds of millions of dollars to buy bond insurance in order to sell municipal bonds needed for important public purposes, such as building schools, roads and hospitals. The unlawful acts of the Defendants have perpetuated an unfair dual rating system that forced public entities to buy bond insurance, at the cost of hundreds of millions of taxpayer dollars. California public entities, including Oakland, should not have had to buy that bond insurance.

2. The situation however reached disaster levels when those same bond insurance companies, who took **hundreds of millions** of dollars in premiums from California public entities, then insured **hundreds of billions** of dollars of ***subprime loans***. The insurer Defendants never disclosed the extent of their exposure to the subprime market but rather represented to Plaintiff Oakland and other California public entities that the bond insurance they were selling would improve their credit rating and lower the interest rate they would have to pay. In that way, the Defendants sold worthless bond insurance.

3. "We know there was a concerted effort among supposed competitors to maintain the dual rating system and kill attempts at reform. There were discussions amongst insurers aimed at retaining the dual rating system when at

least one rating agency suggested modifying or eliminating it. **The effect of these activities was clearly to maintain prices and prop up the market for bond insurance. Such misuse of market power and restraint of competition is plainly anticompetitive and anti-taxpayer, causing direct harm to municipal and state customers issuing bonds."** Connecticut Attorney General in testimony before the House Committee on Financial Services on March 12, 2008.

4. "For years, municipalities have been held to a higher standard than corporate issuers. This differential treatment undermines the functioning of an efficient and transparent capital market, a goal shared not just by investors and issuers, but rating agencies as well. For investors, the current system greatly inflates the risk of investing in municipal bonds relative to alternative investments, leading to investment decisions that are not based on the best information. For municipalities, the dual standard has **cost our taxpayers and ratepayers billions of dollars** in increased interest costs and bond insurance premiums." Letter from Hon. Bill Lockyer of California and 15 State Treasurers to Fitch Ratings, Moody's Investor Services and Standard & Poor's dated March 4, 2008.

5. States, municipalities and public entities issue bonds to fund critical public projects like bridges, schools, roads, sewer plants, libraries, prisons and drinking water systems. The interest rate paid on these bonds depends mainly on the ratings assigned to the bonds by the Credit Rating Agencies. A bond rated "AAA" will bear a lower interest rate than a bond rated "A." As such, the taxpayers in a municipality with an "A" rating will pay substantially more interest over the life of the bond, which can range up to 30 years. This constitutes a significant cost to public entities, many of which rely extensively on municipal bond proceeds to finance public works.

6. Bond ratings are a grade given to bonds that indicate their credit quality. The three major bond rating agencies in the country, **Fitch Inc., Moody's Corporation,** and **Standard & Poor's** ("Credit Rating Agencies"), provide these

evaluations which are supposed to be based upon bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Bond ratings are expressed as letters ranging from "AAA," which is the highest grade, to "C" (junk), which is the lowest grade. The rating services all use letter grades, but use various combinations of upper- and lower-case letters to differentiate themselves.

7. In order for municipal entities to sell bonds at lower interest rates, they are often required to enter into agreements with **bond insurance companies.** In California, the largest municipal bond insurance companies that formerly had AAA ratings are Ambac Financial Group, Inc., MBIA Inc., XL Capital Assurance, Inc., Financial Guaranty Insurance Company, and CIFG Assurance North America, Inc. (the "Insurer Defendants"). The bond insurance company provides a guarantee that they will cover interest payments and the principal payment if the issuer defaults. This serves to lower the interest rate on a municipal bond issuance. For this "service," the Defendant bond insurance companies collect a fee from the public entities.

8. In simple terms, a public entity and a corporate entity may have the same likelihood of defaulting on their debt. The purpose of a bond rating is to inform investors of the likelihood of default on loans by different entities. As a result of different rating systems, however, these two entities, who are otherwise similar, may receive different ratings, *e.g.* the public entity may be rated "A" while the corporate entity may be rated "AAA." Despite the fact that these entities possess the same default risk, the public entity's borrowing costs are significantly higher then the corporate entity. This is the result of the dual bond rating system created by the Credit Rating Agencies which is now the subject of great debate and investigation.

9. Through this discriminatory system, public entities have been forced, and the taxpayers who support those public entities, to pay the insurer Defendants

unnecessary insurance premiums. The difference between an uninsured bond issuance and an insured bond issuance for a municipal entity below "AAA" (which virtually all are) can amount to millions of dollars in increased interest paid to the purchasers of the bonds. California municipalities and public entities are forced to either pay higher interest rates on the issuance of a bond or pay premiums to bond insurance companies. The Defendants conspired to maintain that dual rating system because they knew it was the backbone of their entire industry.

10. The insurer Defendants are corporate insurance entities that are (or at least were) rated "AAA" under the corporate standard. When the insurer Defendants insure a bond offering their credit rating is attributed to the bond rather than the credit rating of the issuer. In essence, a public entity with a lower default risk (the more trustworthy entity) has to pay the bond insurance company (the less trustworthy entity) millions of dollars in insurance premiums in order to receive the benefit of lower interest rates. This situation is not economically rational and serves as a detriment to public entities and has led to unnecessarily high borrowing costs for public entities and unlawful profits for the insurer Defendants.

11. Insuring municipal bonds is an extremely low-risk business in which the insurer Defendants basically receive hundreds of millions of dollars for **doing nothing** as municipalities rarely, if ever, default. The default rate for municipal bonds is minuscule in comparison to corporations — the municipal bond default rate is 0.06 while the default rate on corporate bonds is 0.30 nationally over the past decade. In other words, corporate bonds, in general, are **five times** more likely to default than are municipal bonds.

12. Most bond insurance companies would not even insure California public entities that had even a remote risk of default. The Securities Industry and Financial Markets Association Web site indicates that the insurer Defendants

followed a "zero-loss" underwriting standard, in essence only insuring those municipal bonds that had a **zero percent** chance of defaulting and collecting fees to insure those bonds.

13. This demanding standard that the insurer Defendants have levied against the Plaintiff and other California public entities is in complete contrast to their own irresponsible behavior in insuring hundreds of billions of dollars of high risk subprime mortgage instruments and other complex leveraged instruments based on subprime mortgage instruments.

14. The recent wave of downgrades of all of the insurer Defendants demonstrates that the municipal bond insurance industry has been built on a deceptive foundation. All of the insurer Defendants not only insured the safe debt of public entities such as the Plaintiff Oakland, but recently started insuring risky subprime loans and structured financial products based on those subprime loans, including Collateralized Debt Obligations ("CDO"), all in the name of greed. At the end of 2007, bond insurance companies backed at least **$127 billion of CDOs** based on subprime loans. When these subprime loans began to fail, the risk incurred by the insurer Defendants in insuring these CDOs became starkly visible. Accordingly, as the credit ratings of the insurer Defendants were downgraded, the rating of bond issuances insured by the insurer Defendants were also downgraded. The insurer Defendants' highly risky involvement in the subprime markets was **never disclosed** by the Defendants to Plaintiff Oakland and other California cities and municipalities. If they had known that the insurer Defendants had billions of dollars in exposure to risky subprime and subprime-related instruments, Plaintiff **would not** have purchased bond insurance that has become basically worthless.

15. With the revelation of the recent collapse of the subprime market and the security instruments that were based on the subprime market, the financial conditions of all of the insurer Defendants have suffered. The extent of the insurer Defendants' extremely risky investments in subprime mortgage-backed securities

and insurance of risky subprime loans were never disclosed to the Plaintiff. Even now, the news on a daily basis reveals more and more about the inability of the bond insurance companies to support the promises they made to Oakland and other California public entities. The insurer Defendants have all seen their credit ratings drop recently and at least two have dropped to junk status. The municipal entities have proven to be far less likely to default than the insurance companies that they paid to guarantee their debt. In short, Plaintiff paid insurance premiums for nothing.

16. As **bond insurance companies**, the insurer Defendants were motivated to: (a) artificially lower the credit ratings of bond issuers (*i.e.* municipalities and cities); (b) maintain their own high credit rating and (c) charge high premiums for bond insurance. The insurer Defendants' entire business model rested on these predicate facts. Without one or the other, the insurer Defendants would not be able to receive the high premiums from Plaintiff Oakland and other California municipal and public entities. The first goal was achieved by conspiring to misuse their dominant control of the bond insurance market to perpetuate and maintain the dual bond rating system. The second goal was achieved by failing to disclose their true risk profile by recklessly endangering their "AAA" status by insuring subprime loans and investing in exotic subprime financing instruments.

17. The insurer Defendants misled Plaintiff Oakland by failing to disclose the full extent of their investment in subprime mortgage-backed securities and their insurance of subprime instruments. Those agreements greatly jeopardized the financial condition of the insurer Defendants. As a direct result of being misled, Plaintiff entered into bond insurance agreements with entities that were in substantially worse financial condition than California public entities, such as Plaintiff Oakland, believed. As such, Plaintiff suffered harm from paying unnecessary premiums and costs for bond insurance from financially weak

companies. Plaintiff Oakland paid a premium to acquire a certain product (insurance from a triple-A rated entity) that, due to the wrongdoing of the Defendants, is no longer the same product it thought it had acquired.

II.

NATURE OF THE ACTION

18. This action arises from the illegal and unlawful acts of the Defendants in selling bond insurance to Oakland while offering little or no benefits in reality. The Defendants conspired to maintain and perpetuate the dual rating system in order to force California public entities to purchase bond insurance. The Defendants compounded this wrongdoing by recently insuring hundreds of billions of dollars of subprime loan instruments and failing to disclose that fact to the Plaintiff and other California public entities. These two factors combined to cause great harm to Plaintiff Oakland, forcing them to spend millions of taxpayer dollars for worthless bond insurance. As a result, Plaintiff paid unnecessary premiums and costs because of the conduct of the insurer Defendants.

19. The misconduct of the Defendants was solely for the financial benefit of the Defendants. In the face of the downgrading of the insurer Defendants, Moody's and Fitch have now all but admitted that the dual rating system is flawed and are overhauling and updating all of their municipal bond ratings. Initial estimates suggest that a large number of municipalities and public entities that were formerly below "AAA" (and thus had to buy bond insurance) will be rated "AAA." Standard & Poor's has now upgraded more then 5,000 municipal bonds and has indicated further upgrades may be forthcoming. This dual rating system, which was illegally propped up by the bond insurance companies, was unfair. Even accepting the system as unfair, the insurer Defendants had no business exposing themselves to hundreds of billions of dollars of high risk sub-prime liability while simultaneously insuring municipal bonds.

III.

JURISDICTION AND VENUE

20. Defendants, and each of them, are subject to the jurisdiction of this Court by virtue of their business dealings and transactions in California, by having caused injuries through their acts and omissions throughout the State of California, and by their violation of California state common law and the Cartwright Act, Business & Professions Code §§ 16700, *et seq.*

21. This Court has subject matter jurisdiction over all causes of action asserted herein pursuant to Article VI, § 10 of the California Constitution. Each cause of action asserted, including claims alleging violations of the Cartwright Act, arises exclusively under the laws of the State of California. No part of this complaint arises under federal law, is preempted by federal law, implicates any filed rate, or challenges conduct within any federal agency's exclusive domain, and adjudication thereof has not been statutorily assigned to any other court or jurisdiction.

22. The damages suffered by the Plaintiff exceed this Court's jurisdictional minimum.

23. Each Defendant has sufficient minimum contacts within California to make the exercise of jurisdiction over each Defendant by California courts consistent with traditional notions of fair play and substantial justice. Each Defendant participates, or during the relevant period did participate, in the California market through the sale of municipal bond insurance to California state and local municipalities and public entities.

24. Venue is proper because certain of the Defendants resided, transacted business, were found, or had agents in this county, and because Plaintiff's claims arise directly from business conducted in the City and County of San Francisco. Several of the Defendants are citizens of the State of California, including Defendants Jason Kissane and Neil Pack. All of the Defendants do substantial

business in the State of California and are thus subject to personal jurisdiction in California state court. The Plaintiff in this action is a California public entity that has suffered financial losses due to the illegal and unlawful conduct of the Defendants. The monies lost are those of Oakland residents.

IV.

PARTIES

A. Plaintiff

25. Plaintiff **City of Oakland ("Oakland")** is a California public entity that has issued municipal bonds and has bought municipal bond insurance from one or more of the insurer Defendants. For example, the City of Oakland purchased bond insurance from XL Capital Assurance, Inc., whose credit rating has recently sunk beneath the City of Oakland's own credit rating of 'A1." The City of Oakland has been subject to the dual rating system, under which Oakland was required to buy bond insurance in order to issue bonds at reasonable interest rates. Oakland has suffered losses from the acquisition of bond insurance from the Defendants. Finally, Oakland has had to endure higher interest rates because of the failing financial conditions of the Defendants. Plaintiff alleges that the premiums that it was forced to pay in order to acquire bond insurance was subject to the unlawful and illegal acts of the Defendants.

B. Defendants

26. **Ambac Financial Group Inc. ("Ambac")** is a Delaware corporation with its principal place of business in New York, NY. Ambac's principal operating subsidiary, Ambac Assurance Corporation, is a guarantor of public finance and structured finance obligations. Ambac sold bond insurance to Oakland in the State of California. Ambac is one of the largest providers of municipal bond insurance in the State of California.

27. **MBIA Inc. ("MBIA")** is a Connecticut corporation with its principal place of business in Armonk, NY. MBIA sold bond insurance to Oakland in the

State of California and is one of the largest providers of municipal bond insurance in the State of California.

28. **XL Capital Assurance Ltd. ("XL Capital")** is a wholly-owned subsidiary of Security Capital Assurance Ltd. Its principal place of business is located in New York, NY. XL Capital sold bond insurance to Oakland in the State of California. XL and its parents and subsidiaries are one of the largest providers of municipal bond insurance in the State of California.

29. **Financial Guaranty Insurance Company ("FGIC")** is a New York corporation with its principal place of business in New York, NY. FGIC is a subsidiary of FGIC Corporation, a Delaware corporation. FGIC sold bond insurance to Plaintiff Oakland in the State of California and is one of the largest providers of municipal bond insurance in the State of California.

30. **CIFG Assurance North America, Inc. ("CIFG")** is a New York corporation with its principal place of business at 825 Third Avenue, 6th Floor, New York, NY 10022. CIFG is a subsidiary corporation of CIFG Guaranty, Ltd., a French *societe anonyme.* CIFG sold bond insurance to California public entities in the State of California and is one of the largest providers of municipal bond insurance in the State of California.

31. **Jason Kissane ("Kissane")** is a citizen of California and is a managing director of MBIA's Global Public Finance Division and head of the company's San Francisco office. As the head of MBIA's San Francisco office, Mr. Kissane oversees MBIA's new business activities in the western region of the United States and manages MBIA's insurance business in the western United States including that of Oakland. As managing director of MBIA's Global Public Finance Division, Mr. Kissane knew of MBIA's actual exposure to the subprime markets, an exposure that jeopardized the insurance product he and his division were selling to California public entities. Mr. Kissane also knew and acted in

concert with the other Defendants to maintain the dual rating system. Mr. Kissane is a resident of San Francisco.

32. **Neil Pack ("Pack")** is a citizen of California and is the managing director and head of the US Public Finance - Western Region division of Defendant CIFG. Mr. Pack operates out of CIFG's office in San Francisco, California. Prior to joining CIFG, Mr. Pack spent five years as a managing director at Defendant XL Capital. Mr. Pack is responsible for CIFG's municipal bond insurance business in the western United States including that of Oakland. As a managing director at both Defendant XL Capital and Defendant CIFG, Mr. Pack knew of the massive exposure to the subprime markets that both Defendant XL Capital and Defendant CIFG possessed, an exposure that jeopardized the product he and his division was selling to California public entities. Mr. Pack also knew and acted in concert with the other Defendants to maintain the dual rating system. Mr. Pack is a resident of Contra Costa County.

33. **Ambac, MBIA, XL Capital, FGIC, CIFG, Kissane and Pack** are referred to throughout as the **Defendants.**

C. Doe Defendants

34. Except as described herein, Plaintiff is ignorant of the true names of Defendants sued as Does 1 through 50 inclusive and, therefore, sues these Defendants by such fictitious names. Plaintiff will seek leave of the Court to amend this Complaint to allege their true names and capacities when they are ascertained.

35. Plaintiff alleges that each of these Doe Defendants is responsible in some manner for the acts and occurrences alleged herein, and that Plaintiff's damages were caused by such Doe Defendants.

D. Credit Rating Agencies

36. **Fitch Inc. ("Fitch")**, which does business in California as Fitch Ratings, is a Delaware corporation with headquarters in New York, NY and in

London, England. Fitch is part of the Fitch Group, which is a subsidiary of France-based Fimalac. Fitch is one of the three major municipal bond rating agencies.

37. **Moody's Corporation ("Moody's")** and its subsidiary Moody's Investors Service, Inc. are Delaware corporations with their principal place of business in New York, NY. Moody's is one of the three major municipal bond rating agencies.

38. **Standard and Poor's ("S&P")** is a division of McGraw-Hill Companies, Inc. and has its principal place of business in New York, NY. S&P is one of the three major municipal bond rating agencies.

39. **Fitch, Moody's and S&P** are referred to throughout as the **Credit Rating Agencies.**

E. Agents and Co-Conspirators

40. At all times relevant to this complaint Defendants, and each of them, were acting as the agents, employees, and/or representatives of each other, and were acting within the course and scope of their agency and employment with the full knowledge, consent, permission, authorization and ratification, either express or implied, of each of the other Defendants in performing the acts alleged in this complaint.

41. As members of the conspiracies alleged below, each of the Defendants participated and acted with or in furtherance of said conspiracy, or aided or assisted in carrying out the purposes of the conspiracy, and have performed acts and made statements in furtherance of the conspiracy and other violations of California law.

42. Each of the Defendants acted both individually and in alignment with other Defendants with full knowledge of their respective wrongful conduct. As such, the Defendants conspired together, building upon each other's wrongdoing, in order to accomplish the acts outlined in this complaint.

43. Defendants are individually sued as principals, participants, and aiders and abettors in the wrongful conduct complained of and the liability of each arises from the fact that each has engaged in all or part of the improper acts, plans, schemes, conspiracies, or transactions complained of herein.

V.

WRONGDOING CENTERED IN SAN FRANCISCO

44. Plaintiff Oakland has suffered great harm from the wrongful acts of the Defendants. California is the largest municipal bond issuer in the United States with about $43.7 billion of general obligation debt outstanding. According to the California State Treasurer, in 2007 alone, the State of California sold $12.1 billion of general obligation bonds. Add the outstanding general obligation debt of California cities, counties, districts and other public entities, and it is easily the biggest and most lucrative market in the country for municipal bond insurance. As such, the totality of the harm addressed in this complaint has been suffered by California taxpayers and the residents of Oakland in particular.

45. All of the insurer Defendants conduct a good portion of their business in San Francisco. Indeed, while formally headquartered across the world, all of the insurer Defendants conduct significant business in California. Due to the sheer size of the California municipal bond market, all of the insurer Defendants operate in the State of California and the majority of the Defendants operate major offices in the **financial district of San Francisco.** It is here that the locus of the unlawful conduct against California cities and municipalities is directed from. For example:

46. **MBIA Inc.** registered on June 29, 1989 with the California Secretary of State. MBIA maintains a California office at **150 California Street, 20th Floor, San Francisco, CA 94111.** According to the MBIA website, the San Francisco office is the home of MBIA's Global Public Finance Division. The San Francisco

office is responsible for MBIA's marketing and insurance operations in the western United States including Plaintiff Oakland.

47. **XL Capital Assurance Inc.** registered on October 10, 2001 with the California Secretary of State. XL Capital Assurance Inc. maintains a California office at **595 Market Street, Suite 2210, San Francisco, CA 94105.**

48. **CIFG Assurance North America, Inc.** registered as a business entity on September 17, 2003 with the California Secretary of State. CIFG Assurance North America, Inc. maintains a California office at **Spear Tower, One Market Street, Suite 3500, San Francisco, CA 94105.**

49. **Ambac Assurance Corporation** registered on September 28, 1971 with the California Secretary of State.

50. **Financial Guaranty Insurance Company** registered on July 28, 1972 with the California Secretary of State.

VI.

OVERVIEW OF THE MUNICIPAL BOND MARKET

A. Municipal Bonds

51. Municipal bonds are issued by Oakland and other California cities and counties to raise funds for various public projects, including the construction and repair of roads and building public structures such as schools, parks, power plants and mass transit. Municipal bonds are tax-exempt and as a result, investors are usually willing to accept lower interest rates from municipal bonds then they would accept from other forms of borrowing (assuming comparable risk).

52. Municipal bonds bear interest at either a fixed or variable rate of interest. The issuer of a municipal bond receives the proceeds of the bond at the time of issuance. In return, the issuer agrees to repay the principal and the interest to the bond holders over time. Repayment periods vary and may be as short as a few months but typically last for several years.

53. There are various types of municipal bonds. General obligation bonds are a form of long term borrowing that is backed by a public entity's general fund, including its power to levy taxes. Revenue bonds are a form of long-term borrowing in which the debt obligation is generally not backed by the public entity's general fund, but is instead secured by a revenue stream produced by the project being financed or by a municipal enterprise such as an airport or a water sewer system. Lease-revenue bonds are a variant of revenue bonds used in the state's capital outlay program and also by Oakland. The revenue stream backing the bond is usually created from lease payments made by the occupying department to the governmental financing entity which constructs the facility. The financing authority constructs the facility, issues financing bonds, and retains title to the facility until the debt is retired.

54. The municipal bond industry is extremely large. According to the Securities Industry and Financial Markets Association, approximately $385 billion worth of municipal bonds were issued in 2006. The total United States municipal bond market is currently valued at approximately $2.6 trillion. At any time, California has several thousand bond issuances outstanding. The total market value of the California bond market is approximately $200 billion. In the last year, it is estimated that public entities in California issued approximately $20 billion of municipal bonds.

B. <u>History of Bond Ratings</u>

55. In 1909, John Moody introduced a simple grading system for railroad bonds, which was broadened a few years later to include all industrial bonds. John Moody's grading system was one of the precursors to the modern system of rating security instruments.

56. Poor's Publishing was second in the business in 1916; Standard Statistics followed in 1922. The two companies merged in 1941, forming Standard & Poor's, which was absorbed by McGraw-Hill in 1966. In 1924, Fitch

Publishing made its entrance into the industry. The value of the ratings companies for investors was based on the theory that ratings provided by presumptively objective voices of expertise would assist bond investors in determining which companies were good credit risks and which were bad risks.

57. The 1930s brought the first major change that affected the industry. In the early 1930s, bank regulators began to make judgements about the soundness of banks based on the quality of corporate bonds in which the banks had invested. By 1936, regulators had settled on a requirement that banks could not invest in bonds that were below "investment grade." These changes in bank regulation were followed in the 1930s and 1940s by changes in state regulatory requirements for insurance companies that linked those firms' capital requirements to the ratings of the bonds in the companies' investment portfolios.

58. The next major change for the industry came in the early 1970s, when the industry changed its business model from the "investors pay" model to an "issuers pay" model. The other changes of the 1970s occurred in 1975. The SEC wanted to use bond ratings as a basis for credit quality determinations. Therefore, the SEC created a new regulatory category, "nationally recognized statistical rating organizations" (NRSROs). The three rating company incumbents, Moody's, S&P and Fitch, were immediately "grandfathered" into the NRSRO category. For the next 25 years, the SEC designated only four additional firms as NRSROs. However, mergers among them reduced the net number of NRSRO firms back to the original three.

C. <u>History of Municipal Bond Insurance</u>

59. Bond insurance is a service where the issuer of a bond can pay a premium to a third party bond insurer, who guarantees repayment of interest and principal as specified in the bond in the event that the issuer fails to do so. This in turn raises the rating of the bond to the rating of the insurer. The bond insurer's credit rating must be very good in order for this to happen. The premium

requested for insurance on a bond is a measure of the perceived risk of failure of the issuer. Municipal bond insurance was introduced in the US in the early 1970's.

60. The first monoline insurer, Ambac Financial Group, Inc., was formed in 1971 as an insurer of municipal bonds. The second major monoline insurer, MBIA, Inc. was formed in 1973. Today, Ambac and MBIA are the largest insurers of municipal bonds in California.

61. In recent years, much of the monolines' growth has come through insuring structured products, such as asset backed bonds and collateralized debt obligations (CDOs), and the total outstanding amount of paper insured by monolines reached $3.3 trillion in 2006. By insuring these risky investments, the municipal bond insurers seriously jeopardized their own creditworthiness and created problems for the California public entities that purchased insurance from them, as detailed below.

D. Auction-Rate Securities

62. Auction rate securities ("ARS") are instruments, typically long-term bond investments with characteristics of a short-term investment built into the instrument through the auction mechanism. As a result, underwriters and other brokers have pitched ARS to issuers as securities with long-term maturities but which function as cash equivalents. ARS can consist of municipal bonds, corporate bonds, and preferred stock funds. Historically, ARS have primarily been municipal bonds in which the issuers include states, cities, hospitals, water districts and schools. With the benefit of bond insurance, many of these ARS instruments were "AAA" rated.

63. ARS underwriting firms and other financial institutions presented ARS investments to issuers as a way to take advantage of lower short-term interest rates, even on long-term debt issues. Issuers were informed that auctions would not fail, especially with the backing of "AAA" rated bond insurance companies.

Issuers looked to ARS instruments as a way to obtain short-term interest rates on long term debt issues.

64. Depending on the specifics of the ARS documents, interest rates are reset typically every 7, 14, 28 or 35 days. Existing holders of ARS securities and potential investors periodically reset the interest rate on a security's coupon through a formalized bidding process known as a "Dutch Auction" or reverse auction. In the Dutch Auction, the interest rate is initially set at a presumably economically unattractive level and then made more attractive to purchasers throughout the course of the auction. Bids are typically offered until all the securities at the auction are sold. In this manner, the Dutch Auction theoretically establishes the equilibrium rate at which supply equals demand. This process continues every 7, 14, 28 or 35 days, depending on the specific structure of any given Dutch Auction. The period of time between Dutch Auctions is commonly referred to as the "holding period."

65. In a standard Dutch Auction, bidders are permitted to enter 1 of 4 different orders:

(1) Hold Order (keep the shares out of the auction regardless of the new interest rate).

(2) Hold at Rate Order (sell the shares only if the clearance rate is lower than the bid to hold rate).

(3) Sell Order (sell the shares regardless of the clearance rate).

(4) Bid Order (buy a new position at a specific interest rate).

66. If a bidder "wins" the auction, he or she is required to purchase the bond and is entitled to receive interest at the auction's "clearing rate."

67. The rate at which all securities were sold is called the "clearing rate." The point at which the last available security is allocated to the lowest remaining bidder triggers the clearing rate. The clearing rate will apply to the entire block of securities, even though the rate may be higher than the lowest bid. If several

bidders have bids at the clearing rate, and there are more bids than shares, the shares are divided pro-rata between the clearing rate bidders.

68. For example, a hypothetical ARS sale for $100,000 contains four buy bids:

- Bid A was for $50,000 at 1.10%.
- Bid B was for $50,000 at 1.15%.
- Bid C was for $50,000 at 1.15%
- Bid D was for $25,000 at 1.20%

69. Here, the "clearing rate" would be 1.15%, *i.e.* the lowest rate that would cover all the securities for sale in the auction. (The 1.10% rate, though lower, is not enough to cover all the securities as Bid A was only for $50,000, ½ of the securities up for sale). Bid A would receive $50,000 worth of ARS at 1.15% Bids B and C would receive pro-rate allocations of $25,000 each at 1.15%. Bid D would receive no allocation.

70. If there are insufficient buyers, an auction can fail. For municipal bond issuers, a key factor in the prevention of failed auctions was the fact that municipal bonds had "AAA" ratings because of bond insurance. However, in the last several months, many auctions for ARS failed, to the detriment of California municipal issuers such as the Plaintiff. Potential investors worried that auction bonds would be downgraded because of the bond insurer's exposure to the subprime market and other exotic financial products, such as CDOs. Potential investors also worried about ARS becoming illiquid (*i.e.* not being able to sell the ARS) due to failed auctions.

71. When auctions fail, the clearing interest rate for the ARS cannot be set through the auction, and instead is set by a formula contained in the bond documents. Typically, in such a scenario, the interest rate on the municipal bond skyrockets. In many cases, when auctions fail, the interest rate on ARS securities reach double digits. In 2005, the City of Oakland issued approximately $145

million in ARS revenue bonds that was insured by XL Capital. When XL Capital's insurance rating dropped, the auctions failed and during the time of the auction failure, the City of Oakland was paying 12% interest payments. For many entities like the City of Oakland, interest rates have entered double digits, costing California public entities hundreds of millions of dollars in extra interest payments.

VII.

THE DEFENDANTS HAVE ENGAGED IN UNLAWFUL CONDUCT

72. The insurer Defendants have conspired to maintain the dual rating system and thwart any attempts to reform the system. The insurer Defendants, not content to take advantage of the dual rating system to sell bond insurance, also collected millions of dollars in premiums in order to insure billions of dollars of subprime-based instruments. At first, the insurer Defendants collected record profits. However, as the subprime loans defaulted, the insurer Defendants found their financial condition seriously jeopardized and the product they sold to the Plaintiff Oakland becoming worthless in many respects.

A. Municipal Bonds are Rated by Credit Rating Agencies

73. Municipal bonds are given bond ratings by the Credit Rating Agencies. These bond ratings have a direct effect on the interest rates that California public entities can obtain from the sale of municipal bonds. These bond ratings directly affect the borrowing costs of California public entities, including the Plaintiff. As a result of the dual bond rating system, Oakland was forced to purchase unnecessary bond insurance from the insurer Defendants (because it was unfairly rated lower than corporate entities)

74. According to economists and reports generated by the Credit Rating Agencies, S&P and Moody's each control 40% of the credit rating market. Fitch controls 15%. The three entities combined control approximately 95% of the credit rating market.

75. Rating agencies have held municipal bond issuers to a higher standard than corporate issuers. Unlike corporate issuers, municipal bond issuers are not graded on the risk of default. Municipal entities in general rarely, if ever, default. Nonetheless, public entities issuing municipal bonds are universally given lower bond ratings than similar corporate bonds. This disparity is not merely cosmetic. In fact, it costs California taxpayers hundreds of millions of dollars in the form of either higher interest rates or in the form of premiums and costs related to acquiring municipal bond insurance.

76. The dual system of bond ratings is misleading and misguided – costing California taxpayers billions of dollars in high interest rates and unnecessary costs and premiums. If investors were properly informed of the significantly lower risk of default on municipal bonds, Plaintiff Oakland and other California cities and municipalities would not have to buy municipal bond insurance.

77. As a result of the credit rating system it is impossible for any municipality to publicly sell a bond without a rating. In addition, the market generally made it cost-prohibitive to issue a bond without a "AAA" rating. Hence, the need to buy bond insurance. In essence, the dual rating system created by the Credit Rating Agencies and perpetuated by the Defendants serves the sole purpose of propping up the market for bond insurance. As such, the Defendants have every economic motive and incentive to conspire to maintain and perpetuate the dual rating system. Without it, the entire core business model of the bond insurance companies (a core business model they abandoned) fails.

78. According to the *Los Angeles Times*, tax-free, fixed-rate general obligation bonds issued by cities, counties and local government agencies are generally so safe that all would be rated "AAA" if judged on the same scale as corporate bonds by the Credit Rating Agencies. Moody's recent announcement that it may align municipal bond ratings with corporate ratings included an

acknowledgment that thousands of cities and municipalities would be upgraded to "AAA" if this alignment occurs. However, the dual rating system penalizes municipal bonds under the pretense that state and local government bonds are riskier investments compared to corporate debt.

79. According to Municipal Market Advisors, a respected independent strategy and consulting firm in the insurance industry, corporate bonds with "AAA" ratings, the highest available, have defaulted at ***ten times*** the rate of municipal bonds rated "A", a much lower grade.

80. The Credit Rating Agencies, in their own reports, have long acknowledged the serious problems directly caused by the dual rating system that they created.

81. As early as August of 1999, Moody's issued a report stating, "[s]eparate rating systems with different implied expected loss levels may increasingly lead to suboptimal investment decisions in the future by market participants investing in multiple asset classes, and the risks of rating and regulatory arbitrage are rising."

82. In 1999, Fitch issued a report that acknowledged that many common public bonds - general obligation, tax backed, water/sewer, transportation and education bonds - have "extremely low default rates."

83. In a March 2000 report, Fitch again acknowledged this fact, stating that their own studies "strongly suggest that there are several sectors of state and local government debt that are underrated compared to . . . corporate debt" and that "many ratings in traditional general obligation and essential government enterprise sectors, such as water and sewer utilities, are too low." That study went on to say that ". . . the debt ratings on traditional governmental units and enterprises **<u>understate their inherent safety</u>**, which is Fitch['s] contention after its default study."

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84. For example, a 2001 S&P research report acknowledged that "[m]any sectors of public finance - particularly the general obligation, appropriation ... and certain vital service sectors (like utilities, water, and waste) - evidence relatively **more stability** and **lower default risk** than the corporate sector for a given rating category ..."

85. In October of 2001, an S&P employee briefed S&P's Analytics Policy Board on studies undertaken by S&P showing once more that public sector debt default rates were significantly lower than corporate debt default rates. At the briefing, the S&P employee indicated that S&P needed "to either raise [public bond] ratings or to explain ratings inconsistencies." None of this was done.

86. In a 2002 "highlight" report, Moody's reported that for "the period covering 1970-2000, the one year issuer-weighted average default rate for all Moody's rated municipal issuers - regardless of their rating level - is just .01% versus 1.30% for all corporate issuers." In other words, Moody's own study found that public bonds were on average **130 times** less likely to default than corporate bonds during the first year after issuance.

87. In March of 2003, Fitch's Credit Policy Board ("CPB"), the body within Fitch that considers and makes decisions on its ratings methodologies and procedures, stated that "the default risk on a US municipal bond was lower than on a US corporate bond." The CPB considered issuing a public statement acknowledging that "there in fact does seem to be an inequality of risk in similarly rated corporate and municipal bonds." The CPB never did.

88. In an April 2004 S&P report, it concluded that, "[t]he performance of the sector suggests that public finance issuers have largely outperformed other areas in terms of credit strength. Moreover, Standards & poor's expects these differences to persist and will continue to be evidenced by **relative ratings stability** and **infrequent defaults**."

89. In an October 2005 internal report, S&P's Analytics Policy Board again confirmed that "U.S. public sector entities have historically exhibited substantially lower default rates than corporates, for a given ratings."

90. Studies by the Credit Rating Agencies themselves show that municipal bonds are much less likely to default than corporate bonds.

91. For example, municipal bonds rated Baa by Moody's have experienced a default rate of 0.13 percent compared to a 0.52 percent default rate for corporate bonds that are rated Aaa. In other words, higher rated corporate bonds are **four times more likely to default** than lower rated municipal bonds.

92. Corporate bonds rated AAA by S&P have defaulted at **twice** the rate of lower rated BBB municipal bonds. S&P's historical rate of default of A-rated municipal bonds is .23 percent while the historical rate of default of A-rated corporate bonds is **thirteen times** higher at 2.91 percent.

B. Wrongdoing in the Bond Insurance Industry

93. Defendant insurers Ambac, MBIA, XL Capital, FGIC, and CIFG conspired to support, maintain and perpetuate the dual rating system to squeeze public entities. The Insurer Defendants are able to use the dual rating system to charge excess insurance premiums from municipalities.

94. These premiums are charged even though the Insurer Defendants may be more likely to default than the public entity buying the insurance. Indeed, the Insurer Defendants are being downgraded because the full extent of their previously undisclosed exposure to subprime and other exotic subprime-related instruments is being revealed to the market. As discussed below, all of the Insurer Defendants were downgraded as a result of their heavy involvement in the high risk subprime markets.

95. The Insurer Defendants combined control the bond insurance market in California. The Insurer Defendants have the market power to conspire and control the premiums and costs that public entities are forced to pay in order to

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obtain insurance from the insurer Defendants. As a direct result of the dual rating system, Plaintiff Oakland and other California entities have been required to pay hundreds of millions of dollars for the illusory benefit of insurance from supposedly triple-A rated bond insurance companies.

C. The Bond Insurance Companies Reap Illegal Profits

96. Because of the dual rating system, Oakland and other California public entities could only obtain a "AAA" rating by purchasing bond insurance from the insurer Defendants, thereby assigning the "AAA" ratings of those insurers to the municipal bond. The insurers themselves have been rated "AAA" on the corporate scale and in effect transfer the top rating to public entities through the policies they sell. The profits are enormous – public entities with lower ratings paid $2.5 billion in premiums for bond insurance in 2007, according to the *New York Times*. Moreover, the insurer Defendants charge the entire bond insurance premium up front. They do not provide refunds when a bond issue is refinanced, even when the bond issue was refinanced precisely because the insurer Defendant's credit rating was downgraded.

97. The California State Treasurer has said that to bring up its ratings to what they should have been in the first place, the State of California alone (not including California cities and municipalities such as Plaintiff Oakland) paid $102 million from 2003 to 2007 to buy "AAA" bond insurance on its general obligation bonds, allowing the state to sell the bonds at a lower interest rate. It would have been unnecessary to spend the $102 million if the bonds had been rated by the same criteria as non-municipal debt and there was a competitive market.

98. "Municipal issuers buy insurance on their bonds to obtain a triple-A rating that, in many cases, ***they already deserve***," Bill Lockyer told the House Financial Services Committee. He went on to state that, "[i]f the state of California received the triple-A rating it deserved, we could reduce taxpayer's borrowing costs hundreds of millions of dollars."

99. If California's general obligation bonds received the triple-A rating they deserved, California taxpayers and the State's general fund could save anywhere up to **$5 billion in interest rates over the 30-year life of the bonds.**

100. According to an analyst at Municipal Market Advisors, U.S. taxpayers may pay as much as **$3.6 billion extra** on bonds sold in 2006 because of the different rating standards between municipalities and corporations. Bloomberg.com, March 2008.

D. <u>Conspiracy in the Bond Insurance Industry</u>

101. The insurer Defendants **pay annual fees** to the Credit Rating Agencies for the right to obtain ratings. The insurer Defendants and the Credit Rating Agencies also do significant business together. Through their interlocking business relationships with the Credit Rating Agencies and the fees they pay to the Credit Rating Agencies, the insurer Defendants act to perpetuate and prop up the unfair dual rating system that underpins the entire bond insurance market. According to agreements between the insurer Defendants and the Credit Rating Agencies, the fees paid to the Credit Rating Agencies **increase** as the insurance portfolios **increase** for the bond insurance companies. In addition, issuers of securities are required to pay any additional fees assessed by the Credit Rating Agencies for them to provide a special rating for an "insured offering", *i.e.* issuers may be forced to pay the Credit Rating Agency to give them a new "AAA" rating **after** they have already paid the insurer Defendants for the bond insurance.

102. According to the Connecticut Attorney General, the insurer Defendants have used their complete market power to maintain the dual rating system. In order to maintain their business model and reap hundreds of millions of dollars in profits, bond insurers colluded to pressure Credit Rating Agencies to maintain the dual rating system. They did so in restraint of trade, acts that have caused great harm to Plaintiff Oakland and other California public entities. If not for the subprime explosion that laid bare the fundamentally unfair nature of the

bond insurance industry, the scheme of the Defendants would have likely continued. The Defendants' anti-competitive conspiracy not only perpetuated and maintained the dual rating system, it also permitted the insurer Defendants to charge excessively high insurance premiums in order to receive the illusory benefit of a "AAA" rating.

103. For example, in early 2006, Moody's considered abandoning its dual rating system and instead rate municipal bonds under the same scale it uses for corporate bonds. Moody's prepared a request for comments on this proposed change, which asked "should Moody's . . . assign corporate equivalent ratings to U.S. municipal obligations in all sectors . . ." The proposal was sent to prominent bond insurers, including the insurer Defendants. This proposal, however, was **not sent** to any public bond issuer or other market participant, such as Plaintiff Oakland or other California public entities.

104. The insurer Defendants knew that their entire business model would be seriously harmed if Moody's decided to properly rate public bonds on the same scale as corporate bonds. One bond insurer wrote, "[d]id we know this was coming - at first blush this looks pretty serious to me . . . won't higher ratings just serve to contract spreads. This is **cutting at the heart of our industry** given that investors buy on rating. While we in the industry **might agree with the default/loss conclusion** (this is in part the basis of our success and ability to leverage as high as we are), to lay it out there like this could be very detrimental." An executive at the same bond insurer agreed, "...we know that hardly anybody reads the Moody's special reports so it didn't matter. However, if they actually assign the higher ratings, that's a totally different story..."

105. It is clear that the Defendant bond insurance companies were fully aware of the impact of the dual rating system and its central importance to the functioning of their business. As the bond insurance companies acknowledge, this discriminatory rating system is at the "heart of the bond insurance industry." The

fact that Moody's was suggesting such a change was never disclosed by the Defendants to Plaintiff Oakland or to the marketplace. The fact that the Defendants always knew that the system was discriminatory (even agreeing with the Credit Rating Agencies that the system was discriminatory) was also never disclosed to Plaintiff Oakland or to the marketplace. As the Connecticut Attorney General has alleged in his complaints against the Credit Rating Agencies, no one ever disclosed to Plaintiff Oakland or to the market that they internally recognized and believed they were obtaining large and unlawful profits due to an inherently flawed rating system. The Defendants also never disclosed to Plaintiff Oakland or the market that they knew that the "fine print" explanations regarding the difference between municipal bonds and corporate bonds was not fully understood or appropriately priced in the bond market.

106. To prevent Moody's from abandoning its dual rating system, several bond insurers, including the insurer Defendants, conspired to organize a coordinated response to Moody's request for comments. They did so through the bond insurers' industry association, the Association of Financial Guarantee Insurers ("AFGI"). One bond insurance executive wrote, "I have contacted AFGI to see if we can draft an industry response . . . I think this is important to all, particularly if the wider applicability of this mapping leads to contracted spreads in the muni markets."

107. In May of 2006, top executives from two of the bond insurers met with Moody's top public finance analysts. At that meeting, the bond insurance executives expressed the bond insurance industry's concerns about Moody's proposal to assign credit ratings to municipal bonds using the same ratings scale as for corporate bonds. After the meeting, one bond insurance executive wrote, "Mtg. went well . . . **we were preaching to choir**."

108. As a result of the illegal and unlawful pressure of the insurer Defendants, in June of 2006, Moody's publicly released a modified version of its

requests for comments. The public version of Moody's request for comments dropped any reference to assign "corporate equivalent ratings to U.S. municipal obligations in all sectors" – as had been suggested by the original request for comments that had been secretly provided to the insurer Defendants but not any bond issuer, such as Plaintiff Oakland. Instead, the public request for comments issued in June 2006 only sought comments on whether corporate equivalent ratings should be offered on *taxable* public bonds sold in the United States. Taxable public bonds make up a minuscule portion of the entire public bond market, greatly narrowing the original, non-public proposal. The public request for comments also raised the possibility of entirely eliminating the assignment of corporate equivalent ratings altogether. Moody's made these changes in its public requests for comments because of pressure from the insurer Defendants.

109. U.S. Rep. Michael E. Capuano, a member of the House Committee on Financial Services, described municipal bond insurance as "legal extortion" of cities and states, and said insurance issuers have "stolen billions, if not trillions, of taxpayers dollars from their pockets."

E. The Defendants Failed to Disclose Their True Financial Condition and Risk Exposure to Plaintiff

110. The insurer Defendants have further harmed Plaintiff Oakland and other California public entities and have engaged in unlawful and illegal acts by failing to disclose to the Plaintiff the extent of their exposure to the subprime industry. As the insurers of Oakland's municipal bonds, the insurer Defendants had a duty not to act recklessly and jeopardize their ability to comply with their insurer obligations. If they had fully disclosed their risky and uncertain financial condition, Plaintiff would not have purchased bond insurance from one or more of the insurer Defendants. In the current declining market, Oakland and California public entities have found that the bond insurance they have purchased is close to worthless.

111. A substantial factor in causing the losses suffered by the Plaintiff is the fact that the insurer Defendants have lost their "AAA" corporate standard bond rating and interest rates are rising. Indeed, the insurer Defendants, such as MBIA and Ambac need the fees and costs from municipal bond insurance in order to be able to shore up their own financial conditions. The insurer Defendants' credit ratings and their financial viability have been seriously damaged due to the recent subprime crisis and the losses suffered on mortgage-backed securities.

112. The Defendant insurers earned record profit margins from insuring safe municipal bonds. Between 2002 and 2007, MBIA's average profit margin was 39 percent while Ambac's average profit margin was 48 percent. However, it was not enough. In pursuit of even greater profits, the Defendant insurers dove into the CDO business, insuring **<u>hundreds of billions of dollars</u>** of CDOs backed by subprime loans, seriously jeopardizing their core business: insuring and protecting safe municipal bonds.

113. According to a principal at Capital Markets Management LLC, "It (CDOs) looked so profitable and so easy that they let the portfolio shift too far toward structured finance." He described CDOs as follows:"It morphed into this monster that is devouring them."

114. H. Russell Fraser, one of the founders of bond insurer ACA Financial Guaranty Corp. ("ACA") objected to ACA's decision to heavily enter the CDO market. According to Mr. Fraser, he left the company due to a dispute over the riskiness of ACA's decision to enter into the CDO market. Mr. Fraser stated, "I knew that if they played with fire long enough, they were going to get burned."

115. The insurer Defendants insured hundreds of billions of dollars worth of high risk CDOs (essentially packaged subprime loans). By packaging these products, financial institutions were able to transform extremely high-risk subprime paper into illusory "AAA" paper. Oftentimes the largest holding of some CDOs was even more CDOs. For example, Ambac insured $1.9 billion of a

CDO called Ridgeway Court Funding II Ltd. whose holdings included Carina CDO Ltd., a CDO that was being liquidated in January of 2008. Ridgeway also had exposure to **three other CDOs**, 888 Tactical Fund Ltd., Pinnacle Peak CDO Ltd. and Octonion CDO. Ltd., all of which had exposure to each other and to Carina CDO Ltd. In essence, Ambac's hugely risky $1.9 billion gamble was multiplied tenfold due to the interlocking business relationships of these CDOs.

116. The insurer Defendants entered into the CDO markets out of greed, attracted by the high premiums they could charge while having to set aside very little capital. The Defendant insurers agreed to insure CDOs for billions of dollars even when they knew that **no reliable default rate data existed**. What the Defendant insurers were doing was putting at risk their municipal clients, such as Oakland, by backing hundreds of billions of dollars of high risk loans (without any dependable default rate data) and failing to disclose that exposure. A managing director at New York-based research firm Graham Fisher & Co. was quoted as stating, "They lost their way out of greed." Bloomberg Markets, March 2008.

117. In the past, a managing partner at Pershing Square Capital Management LP challenged the insurer Defendants' business, stating that he believed that the Defendant insurers had larger mark-to-market losses on CDOs than it was disclosing, was underreserving against possible losses and didn't deserve its AAA rating. MBIA's CEO responded firmly, stating that "We stand firmly by the soundness of our book of business and the quality of our underwriting."

118. By chasing the higher profits of CDOs while underestimating the risks, the bond insurers jeopardized their basic business: insuring municipalities against default.

119. Beginning at the end of 2007, Defendant Ambac began to acknowledge serious deterioration in its CDO portfolio and indicated it had more

exposure to anticipated losses and defaults related to its CDO contracts than previously disclosed.

120. On October 24, 2007, Ambac issued a press release entitled, "Ambac Financial Group, Inc. Announces Third Quarter Net Loss of ($360.6) Million; Included Previously Announced $743 Million Unrealized Mark-to-market Loss on Credit Derivative Portfolio; Third Quarter Net Loss Per Diluted Share of ($3.51); Third Quarter Credit Enhancement Production $31.1 million, up 99%."

121. In December of 2007, MBIA announced that it had $8.1 billion in exposure to complex and risky securities backed by home loans.

122. In January of 2008, Fitch downgraded Ambac from "AAA" status to "AA" status.

123. That same month, Fitch said that it was downgrading Security Capital Assurance, the parent company of Defendant XL Capital, because of its expected losses on structured finance collateralized debt obligations ("CDO") backed by subprime residential mortgage backed securities ("RMBS").

124. Moody's and S&P have both placed Ambac and MBIA on negative outlook and are seriously reviewing the financial conditions of both companies. Both Moody's and S&P are considering further downgrades of the credit rating of Ambac and MBIA.

125. In February of 2008, MBIA announced $2.3 billion in losses for the fourth quarter of 2007 on $3.5 billion of write-downs in its insured credit derivatives portfolio.

126. In March of 2008, Security Capital, the parent of Defendant XL Capital, was downgraded to junk status by Fitch, citing serious capital concerns related to the subprime crisis. At the end of last year, Security Capital was one of seven bond insurers with the highest AAA rating. This collapse has caused monetary harm to the public entities that had bought bond insurance from the insurer Defendants.

127. In April of 2008, Fitch downgraded MBIA from "AAA" status to "AA" status.

128. In May of 2008, Defendant MBIA reported a net loss of $2.4 billion, reflecting a $3.6 billion unrealized mark-to-market fall in value on the credit default swaps used by MBIA to insure structured finance credits. MBIA has also announced it is contributing $900 million to its financial guaranty subsidiary.

129. On May 20, 2008, Moody's announced it was downgrading CIFG to "Ba2", which is below investment grade. Moody's announced it was downgrading CIFG because it believed that CIFG would fail to meet minimum regulatory capital requirements due to losses suffered from CDOs.

130. In May of 2008, Defendant FGIC reported that it had lost an additional $33.4 million in the first quarter of 2008 in covering its book of CDO's. FGIC reported that $279.2 million was set aside to cover losses on CDOs of mortgages written from 2005 through 2007. A year ago, Defendant FGIC had reported earnings of $68.5 million and was still rated "AAA" by all three Credit Rating Agencies. In May of 2008, Defendant FGIC was rated Baa3 by Moody's, BB by S&P and BBB by Fitch.

131. On May 28, 2008, Defendant Ambac announced it was writing down an additional $228 million in mark-to-market adjustments on CDO's of asset-backed securities. These losses, similar to the losses suffered by all of the Defendant bond insurance companies, were not appropriately disclosed to the Plaintiff.

132. On June 4, 2008, Moody's announced it was reviewing the financial conditions of Defendants Ambac and MBIA and was seriously considering downgrading both companies because of the magnitude of their losses from insuring risky subprime-related instruments in comparison to their assets. Moody's indicated it had serious questions regarding the ability of Defendants Ambac and MBIA to fulfill their financial obligations as bond insurers.

133. The next day, on June 5, 2008, S&P announced it was downgrading both Defendants Ambac and MBIA to "AA" from "AAA", citing financial weakness and loss of business. Prior to the recent credit rating downgrades, Ambac and MBIA were the two largest monoline insurers in the United States.

134. Four days later, on June 9, 2008, S&P announced it was downgrading Defendant XL Capital further into junk bond status, rating it "BBB-" and on negative credit watch. That same day, S&P downgraded Defendant CIFG to "A-" and placed Defendant FGIC's "BB" rating on CreditWatch with negative implications.

135. On June 19, 2008, Defendants Ambac and MBIA, the two largest bond insurance companies in the State of California, both lost their last triple A rating when Moody's downgraded both companies. Defendant Ambac was downgraded from Aaa to Aa3 with a negative outlook while Defendant MBIA was downgraded to A2.

136. The next day, Moody's announced that it was downgrading Defendant FGIC from Baa3 to B1. Moody's also downgraded FGIC's parent, FGIC Corporation from B3 to Caa2. That same day, Moody's also downgraded Defendant XL Capital to B2 with a negative outlook from A3. Moody's also downgraded Defendant XL Capital's parent company, Security Capital Assurance to Ca from B3. This downgrade lowered both Defendant FGIC and XL Capital's credit ratings to junk status.

137. On July 21, 2008, Moody's announced it was placing two additional "AAA" rated bond insurance companies, Financial Security Assurance, Inc. ("FSA") and Assured Guaranty Corporation ("AGC") on negative review for potential downgrade. In its report regarding AGC, Moody's wrote that a AAA-rating for AGC "may no longer be consistent with its current ratings given **uncertainty about the firm's portfolio risk profile**, material shifts in the demand function for financial guarantees, and as observed recently among Assured's

competitors--potential sensitivity of its franchise and financial flexibility if losses continue to rise."

138. In its report, Moody's also cited serious concerns about FSA's residential mortgage-backed securities, suggesting that "material losses" from those residential mortgage-backed securities could affect FSA's credit.

139. On July 29, 2008, Moody's placed the 'Baa1' senior debt rating of Defendant XL Capital and the 'A1' IFS ratings of XL's insurance operating subsidiaries on review for possible downgrade.

140. That same day, Fitch downgraded Defendant XL Capital's credit rating to CCC from BB, further reducing Defendant XL Capital into junk status.

141. On July 30, 2008, Fitch announced it had downgraded Security Capital Assurance's long term issuer rating to CCC- from B-, significantly deeper into junk status. That same day, Fitch lowered the insurer financial strength ratings for Defendant XL Capital's subsidiaries to CCC from BB. Fitch also stated that if regulatory intervention were to occur because of the losses, it could lower the ratings for Defendant XL Capital and its parent and subsidiaries to default status.

142. On July 31, 2008, Fitch also downgraded FGIC's credit rating from BB to CCC-. Fitch stated that this action was undertaken due to Fitch's expectation that FGIC will experience further credit deterioration on its book of business backed by residential mortgage-backed securities (RMBS). Fitch stated their belief that this deterioration could lead to further additions in loss reserves which will increase the possibility that FGIC could become subjected to some form of regulatory intervention.

143. On August 6, 2008, S&P placed FSA on negative outlook pending review. In their report, S&P stated that absent a major capital contribution, "we believe that FSA's capital adequacy margin of safety would have fallen modestly

below 'AAA' rating standards as a result of deterioration and projected losses in FSA's insured residential mortgage-based securities portfolio and for its financial product line."

144. Richard Larkin, research director at brokerage Herbert J. Simons & Co. in Iselin, New Jersey and the former chief municipal rating officer at S&P, described this as "a watershed moment in the municipal bond industry." Mr. Larkin further stated that, "[t]he bond insurers have lost a tremendous amount of credibility." Bloomberg.com, March 2008.

145. A principal of Pershing Square Capital stated, "What's significant about ACA is that it's the first monoline to blow up. There's nothing materially different about Ambac, FGIC, MBIA or XL Capital. They all have the same problem, that they are highly leveraged, have risky exposures and inadequate reserves."

146. The Defendant insurers have reaped hundreds of millions of dollars in fees from California public entities and cannot now provide the "service" that they claimed that they were providing. Indeed, the only reason Plaintiff Oakland was forced to pay for this "service" was due to the dual rating system.

147. The current situation in the financial markets demonstrates that the Defendants' scheme has forced the more responsible party (public entities) to pay the less responsible party (bond insurance companies) hundreds of millions to acquire a guarantee from the less responsible party. This is akin to paying the fiscally irresponsible younger brother to insure the debt of the responsible older brother.

148. Mr. Fraser, the founder of ACA stated that, "[t]here's no reason for an AAA-rated bond insurer to be doing anything with subprime mortgages." He continued by stating, "It's going to hurt their business because municipalities are going to ask, 'Is this insurance really worth it?'" With the full extent of the

subprime debacle still being uncovered, the answer is increasingly appearing to be "No."

149. For example, California's costs on $100 million of bonds that were issued in 2002 and insured by Security Capital *increased.* The annualized rate on these bonds went up to 6.22 percent on February 20, 2008 because these bonds were guaranteed by Security Capital, which was downgraded. A year earlier, the annualized rate on these bonds was 3.55 percent.

150. The injuries caused by the mortgage defaults have spread throughout the financial system. Municipal bond insurers have lost their triple-A rating or are in serious danger of losing their triple-A rating. Investment funds, such as money market funds and hedge funds are forced to unload municipal bond debt because of both internal rules and, more importantly, Securities and Exchange Commission rules, that forbid them from investing in debt that has not achieved a certain bond rating.

151. If municipal securities had been properly rated, California public entities would not have been forced to pay high insurance premiums and endure higher borrowing costs that are a direct result of their supposed "insurer" losing their triple-A bond rating. In addition, California public entities, including Plaintiff Oakland, would not have had to pay additional refinancing costs if the insurer Defendants had not improperly invested heavily in CDOs.

152. In their agreements with Plaintiff Oakland, the insurer Defendants stated that they were "AAA"-rated entities. Indeed, if not for this promise, Oakland's bonds would not have been upgraded to triple-A. Oakland paid the premiums with the expectation that it was buying insurance from a triple-A rated entity. However, the insurer Defendants failed to disclose to Plaintiff Oakland, and other corporate entities, the true extent of their exposure to the subprime CDO market. Even the Defendants' initial acknowledgments of financial problems tried to downplay the problem. Today, the exposure of the Defendants to subprime

instruments is large enough to cause serious stress to the ability of the Defendants to support their insurance obligations.

153. In addition, the insurer Defendants also issued financial statements that were misleading. In those financial statements, the insurer Defendants reiterated the strength of their financial condition and the fact that they were "AAA" rated entities. However, these statements were false and misleading because the insurer Defendants failed to state that their record profits were being obtained only by insuring hundreds of billions of dollars of high risk subprime instruments.

154. Barney Frank, the chairman of the House Financial Services Committee has stated that the bond insurers, including the Defendants, erred when they insured speculative structure-finance products after backing safe municipal bond deals. "They insured a safe product and then took that money and speculated in ways that they endangered the cities and town that they were insuring." Barney Frank went on to state, "[t]his is the private sector having facilitated harm."

F. Auction-Rate Bonds Have Been the Hardest Hit by the Deception

155. Auction-rate bonds have been hit the hardest and those public entities that have issued auction-rate bonds have been amongst the biggest victims of the improper acts and omissions of the Defendants. As of the end of 2006, the auction-rate securities market had grown to $350 billion.

1. Plaintiff City of Oakland Issued Auction-Rate Bonds

156. The City of Oakland issued auction-rate bonds, one of which was insured by XL Capital Assurance, Inc. Conceptually, XL Capital's triple-A rating was intended to reduce interest rates for the City of Oakland. In that auction-rate bond offering, the City of Oakland did not receive a "AAA" rating until after it had acquired bond insurance from Defendant XL Capital.

157. Moody's Investor Service wrote that it "has assigned the rating of AAA . . . based upon an insurance policy provided by XL Capital Assurance."

Standard's & Poor changed the rating of the City of Oakland's bond issuance to "AAA" from "A+". "The rating reflects our assessment of the likelihood of repayment of principal and interest based on the bond insurance policy [XL Capital Assurance Inc.] is providing." Fitch assigned a rating of 'AAA' to the municipal bonds issued by the City of Oakland. "This reflects credit enhancement in the form of a bond insurance policy provided by XL Capital Assurance Inc. which has an insurer financial strength rating of 'AAA.'"

158. As a result of the dual rating system, the City of Oakland was required to pay an unnecessary premium for the acquisition of municipal bond insurance from XL Capital Assurance Inc.

159. On March 28, 2008, Fitch downgraded XL Capital Assurance Inc. to a "BB" rating. As a result, the City of Oakland's interest payments and borrowing costs rose dramatically, causing harm to the City of Oakland and its taxpayers. Shortly thereafter, Fitch similarly downgraded its rating of the City of Oakland's auction rate securities that had been insured by Defendant XL Capital.

160. After XL Capital's credit rating collapsed below Oakland's artificially low "A" rating, Oakland's interest rates rose. As a result of XL Capital's downgrade, the City of Oakland has been paying 12% interest on their auction-rate bonds and has been forced to spend additional money to refinance those bonds. Oakland had paid insurance premiums for insurance from an insurance entity that was significantly less financially sound than itself and now has been damaged.

2. <u>Auction-Bond Failures Caused by Bond Insurer Downgrades</u>

161. The interest rate on an auction-rate municipal bond resets every few days, for example, 7, 28 or 35 days, depending on the particular characteristics of the bond. The municipal bonds are then sold in a "Dutch auction", as previously described above. The interest rate is thus dependent on the number of investors that want to purchase the municipal bond. The idea is that if a bond is highly

sought after, it will have a lower interest rate then a fixed-rate municipal bond. The flip side, however, is that if no investors are interested, interest rates can reach astronomical levels in order to entice investors.

162. When there are no buyers, this is referred to as a "failed auction." In the situation of a "failed auction", the bond documents dictate the interest rate to be paid on the bond. The interest rate can be in the double digits. But for the acts and omissions of the Defendants, the auctions would not have failed. According to a February 2008 article in the *New York Times*, over 500 auctions failed during the first two weeks of February.

163. Due to the dual bond rating system, auction-rate municipal bonds that should have been rated "AAA" are being unfairly treated as below "AAA." Investment funds that might want to invest are banned from doing so and other investors do not fairly value the true default risk of these municipal bonds. As such, the investor pool shrinks. When the insurer Defendants' financial condition began to deteriorate as a direct result of their exposure to subprime, they were downgraded by the Credit Rating Agencies and investors began to withdraw from these auction-rate municipal bonds. The auction rate municipal bonds themselves were downgraded. The problems with the insurer Defendants led to investors either not wanting or not being able to buy the auction rate municipal bonds. Therefore, the auctions failed and, as a result, municipal entities were forced to endure sometimes double digit interest rates.

164. The Defendant insurers have caused great harm to public entities by both receiving high premiums to insure the municipal bonds of public entities while simultaneously insuring risky mortgage-backed securities backed by subprime loans. By doing so, the bond insurers carelessly risked the triple-A rating that is, in essence, the sole product they are selling to public entities.

165. Numerous public entities have been victims. In one case, a municipal bond that was meant to build hospitals was guaranteed by MBIA. Prior to

February 19, 2008, the interest rate on that municipal bond had been 4.25 percent. However, with the threat of a ratings downgrade on MBIA, the auction failed, leading to an interest rate of 15 percent. *New York Times*, February 2008.

166. Another public entity has found itself paying a 20 percent interest rate on failed auctions. At the top of the list of worries of prospective investors is the precarious financial conditions of the insurer Defendants, such as Ambac and MBIA. The Defendant insurers never fully disclosed the extent of their exposure to the subprime market. *New York Times*, February 2008.

167. In a February 8, 2008 report, Alex Roever, a JP Morgan Chase & Co. fixed income analyst wrote that $6 billion of auction debt failed on investor concerns that bond insurers would lose their "AAA" rating.

168. In May of 2008, the Dormitory Authority of the State of New York ("DASNY") announced that it was converting or refunding up to $1.55 billion of auction rate bonds. As part of that refinancing, DASNY also announced $1.09 billion of new bonds with preliminary approval for an additional $111.5 million of new tax-exempt bonds. DASNY documents indicate that the rating downgrades for several bond insurers adversely affected the marketability of the auction rate bonds.

169. Similarly, the Massachusetts Water Resources Authority ("WRA") announced it would sell $1.6 billion of revenue refunding debt to help it exit the auction-rate market. Auctions failed because of the rating downgrades of Defendant bond insurers Ambac and FGIC. According to the Massachusetts WRA, $2.6 million of additional costs is due directly to the rating downgrades of Defendant bond insurers Ambac and FGIC.

170. The extent of the insurer Defendants' exposure to the subprime loan industry, which caused the auction failures, was never fully disclosed to the Plaintiff Oakland and other California public entities who purchased insurance from the insurer Defendants.

171. Plaintiff Oakland issued auction-rate securities that suffered from high interest rates due to the auction failures. Those high interest rates have harmed Plaintiff Oakland and Oakland taxpayers. Those auction failures are a result of the wrongdoing of the Defendant insurers, all of whom are in serious jeopardy of being unable to fulfill their obligations as insurers to Plaintiff Oakland and other California public entities.

VIII.

CREDIT RATING AGENCIES ADMIT THE FLAWED NATURE OF THE DUAL RATING SYSTEM

172. In a press release, Treasurer Bill Lockyer stated, "Our message to the agencies is simple. ***Treat taxpayers the same as corporations.*** Don't make them pay more to finance schools and roads than corporate entities pay when they bundle bonds into fancy, opaque investment vehicles. Rate municipal bonds based on the risk of default. End the double standard and create a unified, global rating approach that treats all issuers equally, and better serves taxpayers and investors."

173. On March 4, 2008 the California Treasurer and government officials from Oregon, Connecticut and thirteen other states and cities wrote to Fitch, Moody's and S&P to urge them to end the unfair dual standard in rating government bonds. Due to the pressure from government officials such as the California Treasurer, Moody's and Fitch have finally agreed to take some steps to rationalize their rating systems. The resulting scandal has led the Credit Rating Agencies to reevaluate the unfair dual rating system that has long been perpetuated by the Defendants.

174. Fitch assigned Group Managing Director Robert Grossman to "harmonize" the ratings for corporate and public finance ratings.

175. As a result, Fitch, on March 19, 2008, stated, "As we developed our capital model, it was our belief that other models currently used in the market *overstated the risk of many US municipal exposures* insured by the financial

guarantors and understated the risk of many structured finance exposures. We believe this to be evident when reviewing historical default studies that show the default rate on US municipal debt is a fraction of that on corporate debt, whereas the default rate on structured finance debt is equal to, if not moving higher than, that of corporate debt. Thus, a key goal in developing a new model was to address this perceived imbalance found in existing models." On July 31, 2008, Fitch issued its "Exposure Draft: Reassessment of Municipal Ratings Framework." In this report, Fitch proposed "a recalibration of its municipal rating scale for corporate, sovereign, and other entities." Fitch reported that after it completes its recalibration, **<u>86% of state and local general obligation bonds will receive a rating of AA or higher</u>**.

176. Moody's first stated in May of 2008 that it would provide global scale ratings, their term for the corporate standard bond rating, to municipal issuers, at the request of issuers. Moody's also stated that it would simplify the conversion table it uses to estimate global ratings for bonds. This should have been done much earlier so that investors could compare municipal bonds and corporate bonds on a true "apple-to-apple" basis.

177. On June 12, 2008, Moody's reversed course, proposing to alter the rating system for municipal bonds to be in line with its global rating scale for corporations. Gail Sussman, managing director for public finance at the New York-based company, said the change will eventually lead to upgrades of some of its 78,000 municipal ratings. This proposal is an admission that the original dual rating system was flawed, forcing California municipalities to spend hundreds of millions of dollars unnecessarily on bond insurance. Bloomberg.com, June 2008.

178. Recently, S&P has announced that it is appointing an ombudsman to "study" whether there are any "conflicts of interest" in the way it develops ratings. Furthermore, an external firm is being hired to review S&P's ratings to check if

the agency has handled conflicts of interest properly and maintained independence.

179. S&P has now upgraded more than 5,000 municipal bonds in order to bring the rating of these municipal bonds more in line with its criteria for rating corporate bonds. This is also an admission that the dual rating system, which Defendants conspired to pressure the Credit Rating Agencies to maintain, was inherently flawed.

IX.

INDUSTRY ASSOCIATIONS USED FOR CONSPIRACY

180. Industry associations in the municipal bond industry proved to be one of the mechanisms through which the unlawful and illegal acts occurred. During those meetings, discussions and other communications occurred in which the Defendants discussed how to manipulate the system for their benefit. These conferences served as one of the means in which the wrongdoing against California public entities was perpetuated.

181. There are several trade groups the Defendants belong to at which the Defendants engaged in anti-competitive and unlawful behavior. One of the largest groups is the Securities Industry and Financial Markets Association (SIFMA).

182. SIFMA is an industry trade group representing securities firms, banks, and asset management companies. SIFMA was formed on November 1, 2006, from the merger of The Bond Market Association and the Securities Industry Association. SIFMA's mission is to "promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry."

183. Amongst SIFMA's members are Ambac, MBIA, Fitch, Moody's and Standard & Poor's. All of the Defendants used these opportunities to conspire and

perpetuate the scheme that has cost California taxpayers billions of dollars in higher interest rates and borrowing costs and in unnecessary fees and costs.

184. The Information Management Network ("IMN") holds Municipal Finance Conferences in California. At these meetings, municipal bond issuers, municipal bond rating agencies and municipal bond insurance companies meet to discuss and exchange information. The Defendants use these association meetings and conferences as one of many means, including other forms of communication, to conspire to the detriment of California local and municipal entities. The IMN California Municipal Finance Conference has been held at the **Ritz Carlton Hotel in San Francisco for the last two years.** Representatives of the Credit Rating Agencies are present at this conference as are senior representatives of the Defendant insurance companies, including Defendant Jason Kissane, the head of MBIA's San Francisco office and MBIA's West Coast operations, Defendant Neil Pack, the current head of CIFG's San Francisco office, as well as Kathleen McDonough, a senior managing director at Defendant Ambac. At this conference, they discussed the municipal bond insurance industry and how to maintain the bond insurance business by perpetuating the dual rating system.

185. The Bond Buyer holds an Annual California Public Finance Conference in which professionals in the municipal bond industry meet to discuss and exchange information in the municipal bond industry. The Bond Buyer is a major publication focusing on public financing, including municipal bonds. The Bond Buyer's Annual California Public Finance Conference is a meeting place for Defendants to exchange information. It also served as a cover for the Defendants' to perpetuate their wrongdoing. The 17th Annual California Public Finance Conference was held in Carlsbad, California in 2007. Both Defendants Jason Kissane and Neil Pack were present at the California Public Finance Conference where the issues alleged in this complaint were discussed. Representatives from most of the Defendant insurance companies, as well as representatives from the

Credit Rating Agencies were all present at the conference and discussed the allegations made above.

186. The Association of Financial Guaranty Insurers (AFGI), formed in 1986, is one of the biggest trade associations for bond insurance companies. They are the trade association of the insurers and reinsurers of municipal bonds and asset-backed securities. Amongst their members are the major municipal bond insurance companies, including Ambac and XL Capital.

X.

CALIFORNIA PUBLIC ENTITIES SUCH AS OAKLAND SUFFERED INJURY THROUGH THE CONDUCT OF THE DEFENDANTS

187. Through their unlawful acts, the Defendants acted to the detriment of Plaintiff Oakland and other California public entities, leading to the Defendant insurers reaping unlawful profits from California public entities. Oakland alone has paid millions in bond insurance premiums to the Defendant insurers during the past few years for bond insurance that is essentially worthless.

188. The Defendants acted to the detriment of Oakland, as well as other California public entities and California citizens. The wrongful acts of the Defendants have served to unlawfully increase the costs of municipalities for issuing bonds while filling the bank accounts of the Defendants.

189. In so doing, the Defendants have committed unlawful acts that allowed them to illegally and improperly obtain California public monies, including the public monies of Plaintiff Oakland.

190. The nature of the Defendants' unlawful acts has caused serious harm to the Plaintiff and other California cities and counties. As a direct result of the conduct of the Defendants, Plaintiff Oakland and other California public entities paid high premiums for worthless bond insurance. All of this has resulted in serious harm to Plaintiff and other California public entities.

XI.

GOVERNMENT INVESTIGATIONS INTO THE DUAL RATING SYSTEM IN THE BOND MARKET

191. In October 2007, the Connecticut Attorney General's office issued subpoenas to Fitch, Moody's and S&P as part of an overall investigation into the practices of the municipal bond industry. The "investigation seeks to determine whether credit-rating agencies may be exploiting their dominant positions to unfairly raise prices or exclude competitors. Assuming debt ratings are honest and untainted is vital to investors, companies and government." *Wall Street Journal*, October 27, 2007.

192. In a Form 10-Q filed with the SEC Oct. 26, 2007, McGraw-Hill, the parent of S&P, said: "On October 16, 2007, Standard & Poor's received a subpoena from the Connecticut Attorney General's Office requesting information and documents relating to the conduct of Standard & Poor's credit ratings business." The company said it was responding to the subpoena.

193. Moody's disclosed in its 10-Q filed with the SEC on November 2, 2007, that it "has received subpoenas and inquiries from states attorneys general and governmental authorities and is cooperating with those inquiries." No other details were released.

194. The *Wall Street Journal* article quoted Fitch spokesman Jim Cockle as saying Fitch had been contacted by AG's and other regulators. "A lot of regulatory authorities and interested parties are in the process of investigating the ratings agencies, and we are cooperating with all of them," he said.

195. The Connecticut Attorney General testified before the House Committee on Financial services on March 12, 2008, focusing on the rating system for municipal bonds. He said the current dual system of rating bonds issued by public entities "is dangerously misleading and misguided. It imposes a secret Wall Street tax on states, cities and school district across this nation." He also

said the investigation he launched in October "is still ongoing and active" and "focuses on how this unfair system was started and perpetuated, who profits from it, and what anticompetitive effects it has on the prices that states and municipalities pay to borrow for essential projects like schools and roads."

196. The Attorney General charged that the "misuse of market power and restraint of competition" by the municipal bond rating agencies "is plainly anticompetitive and anti-taxpayer, causing direct harm to municipal and state customers issuing bonds."

197. On January 23, 2008, Massachusetts securities regulators subpoenaed documents from Defendants **Ambac** and **MBIA** in order to determine if the insurers informed Massachusetts communities that were trying to raise money about the insurers' own exposure to collateralized debt obligations.

198. Massachusetts' Secretary of the Commonwealth questioned whether Massachusetts cities and towns would have relied on Defendants Ambac and MBIA for financial guarantees to ensure bond investors are repaid if the governments had known about the firms' guarantees of CDOs. The failure of MBIA and Ambac to fully disclose their exposure to CDOs was both illegal and improper.

199. In May of 2008, SEC Chairman Christopher Cox announced that the SEC was considering proposing new rules for Nationally Recognized Statistical Rating Organizations ("NRSRO"). The purpose of these new rules are to: enhance investor understanding of the important differences between ratings for municipal, corporate and structured debt instruments; regulate and limit conflicts of interest, reduce regulatory reliance on ratings and disclose the role of third party due diligence in assigning ratings.

200. In June of 2008, all three of the Credit Rating Agencies entered into settlement agreements with the New York Attorney General in which all three have agreed to change their way of doing business. Most importantly, they have

been forced to resolve their involvement in the subprime market meltdown and avoid the conflicts of interest that affected their ratings of securities.

201. Also, in June of 2008, the SEC announced new rules regulating all NRSROs which would also lead to significantly greater transparency on the part of the Credit Rating Agencies regarding their rating methodology, greater clarity on how to interpret and understand their ratings, and also regulating the conflicts of interests that have tainted the ratings given by the Credit Rating Agencies.

202. On July 31, 2008, Connecticut AG Richard Blumenthal filed three lawsuits in Connecticut state court against all three of the Credit Rating Agencies as a result of the flawed dual credit rating system. In those complaints, the Connecticut Attorney General details how all three of the Credit Rating Agencies knew (since at least 1999) knew that their rating system for municipal bonds was flawed and the impact that flawed rating system had on public entities. Those allegations show both the tremendously flawed nature of the dual rating system and how this has caused significant harm to California public entities, such as Plaintiff Oakland.

XII.

FRAUDULENT CONCEALMENT

203. Throughout the relevant period, Defendants affirmatively and fraudulently concealed their unlawful conduct from Plaintiff Oakland.

204. Plaintiff did not discover, and could not discover through the exercise of reasonable diligence, that the Defendants were engaging in the illegal and unlawful conduct as alleged herein until shortly before this litigation was commenced. Nor could Plaintiff have discovered the violations earlier than that time because Defendants engaged in their wrongdoing in secret, concealing the nature of their unlawful conduct and acts in furtherance thereof, and fraudulently concealed their activities through various other means and methods designed to avoid detection. The nature of the wrongful act itself was to withhold the

disclosure of material financial information about the insurer Defendants from the Plaintiff and other California public entities.

205. Plaintiff could not have discovered the unlawful conduct at an earlier date through the exercise of reasonable diligence because of Defendants' active and purposeful concealment of their unlawful activities. Indeed, it was not until late 2007 and the beginning of 2008 that the insurer Defendants were downgraded and placed on negative credit watch.

206. As a result of Defendants' fraudulent concealment of their wrongful acts, Plaintiff asserts the tolling of any applicable statute of limitations affecting the rights of action of Plaintiff.

XIII.

CLAIMS FOR RELIEF

FIRST CAUSE OF ACTION

BREACH OF THE COVENANT OF GOOD FAITH AND FAIR DEALING

(Against Defendants Ambac, MBIA, FGIC, XL Capital and CIFG)

207. Plaintiff repeats and realleges each of the foregoing paragraphs of this complaint and incorporate them by reference as though set forth in full herein.

208. The insurer Defendants entered into bond insurance contracts with the Plaintiff and owed it a duty of good faith and fair dealing. By insuring risky subprime loans and investing heavily in the subprime markets, the insurer Defendants violated that duty of good faith and fair dealing. By failing to disclose their weak financial condition and the extent of their exposure to the subprime market, the insurer Defendants also violated that duty of good faith and fair dealing. The sole asset that the bond insurance companies sold to the Plaintiff was their "AAA" rating which they improperly and unlawfully jeopardized by insuring subprime loans and other subprime market instruments. The insurer Defendants compounded their wrongdoing by failing to disclose their true risk exposure to

Plaintiff Oakland. If the insurer Defendants had disclosed the nature of their wrongful conduct, Plaintiff Oakland would not have purchased bond insurance from the insurer Defendants.

209. The illegal and unlawful acts alleged herein have had the following effects on Plaintiff: (1) requiring the expenditure of unnecessary taxpayer dollars for the acquisition of municipal bond insurance; (2) being forced to pay unreasonably high interest rates on the issuance of municipal bonds and (3) being forced to incur additional refinancing costs as a result of the Insurer Defendants' misconduct.

WHEREFORE, Plaintiff prays for judgment against Defendants, and each of them, as set forth below.

SECOND CAUSE OF ACTION

FRAUD AND DECEIT

(Against Defendants Ambac, MBIA, FGIC, XL Capital and CIFG)

210. Plaintiff repeats and realleges each of the foregoing paragraphs of this complaint and incorporate them by reference as though set forth in full herein.

211. The insurer Defendants, and each of them, made material representations and omissions to Plaintiff which were false and misleading, including but not limited to those representations and omissions as to the financial condition of the Defendants. These material misrepresentations and omissions are contained in and reflected in public statements, including financial statements, and other disclosures made by the Defendants.

212. The insurer Defendants had an obligation and duty to disclose to the Plaintiff that they had exposed themselves to risky subprime loans and that their triple-A credit rating was not deserved. The Defendants, and each of them, made the representations and failed to disclose and suppressed information they had a duty to disclose, as set forth hereinbefore. The Defendants did so with knowledge

of the falsity of their statements and representations and knew that they were failing to disclose material facts which they had a duty to disclose.

213. At the time these misrepresentations were made and the material facts not disclosed, the Plaintiff was ignorant of the true facts. If the Plaintiff had known the true facts, they would not have purchased bond insurance from the Defendants.

214. Plaintiff reasonably relied on Defendants' representations in purchasing municipal bond insurance from the insurer Defendants.

215. As a direct and proximate result of the wrongful conduct of each of the Defendants, Plaintiff purchased bond insurance from the Defendants and has since suffered and will continue to suffer economic losses and other general and specific damages, all in an amount to be determined according to proof.

WHEREFORE, Plaintiff prays for judgment against Defendants, and each of them, as set forth below.

THIRD CAUSE OF ACTION
BREACH OF CONTRACT

(Against Defendants Ambac, MBIA, FGIC, XL Capital and CIFG)

216. Plaintiff repeats and realleges each of the foregoing paragraphs of this complaint and incorporate them by reference as though set forth in full herein.

217. Plaintiff entered into bond insurance agreements with the Defendant bond insurance companies. As part of those agreements, the Defendants had a duty to act in good faith to maintain their triple-A rating. Indeed, the purpose of the contract was to acquire insurance from a "triple-A" bond insurance company, not a company that had billions of dollars of hidden exposures and liabilities. The size and extent of those liabilities were massive enough to jeopardize the "triple A" rating of the bond insurance companies, the very product the bond insurance companies were selling to Plaintiff Oakland.

218. Oakland has performed each and every act required to be performed by it pursuant to the bond insurance agreements.

219. The insurer Defendants have breached the insurance agreements through their reckless conduct in exposing themselves to the subprime markets for billions of dollars.

220. As a direct and legal result of this breach of contract, Plaintiff Oakland has been damaged in an amount to be ascertained at the time of trial.

WHEREFORE, Plaintiff prays for judgment against Defendants, and each of them, as set forth below.

FOURTH CAUSE OF ACTION

NEGLIGENT MISREPRESENTATION

(Against All Defendants)

221. Plaintiff repeats and realleges paragraphs ¶¶ 1 - 206 of this complaint and incorporate them by reference as though set forth in full herein.

222. The insurer Defendants, and each of them, made material representations and omissions to Plaintiff which were false and misleading, including but not limited to those representations and omissions as to the financial condition of the Defendants. These material misrepresentations and omissions are contained in and reflected in public statements, including financial statements, and other disclosures made by the Defendants.

223. The Defendants had an obligation and duty to disclose to the Plaintiff that they had exposed themselves to risky subprime loans and that their triple-A credit rating was not deserved. In making the representations and omissions, and in doing the above things alleged, Defendants, and each of them, acted without any reasonable grounds for believing their representations were true, and intended by said representations to induce the reliance of the Plaintiff to purchase bond insurance. Plaintiff relied upon these false representations, concealments, and

nondisclosures by Defendants, and because of this, purchased bond insurance from the Defendants.

224. At the time these misrepresentations were made and the material facts not disclosed, the Plaintiff was ignorant of the true facts. If the Plaintiff had known the true facts, they would not have purchased bond insurance from the Defendants.

225. Plaintiff reasonably relied on Defendants' representations in purchasing municipal bond insurance from the insurer Defendants.

226. As a direct and proximate result of the wrongful conduct of each of the Defendants, Plaintiff purchased bond insurance from the Defendants and has since suffered and will continue to suffer economic losses and other general and specific damages, all in an amount to be determined according to proof.

WHEREFORE, Plaintiff prays for judgment against Defendants, and each of them, as set forth below.

FIFTH CAUSE OF ACTION

NEGLIGENCE

(Against Defendants Ambac, MBIA, FGIC, XL Capital and CIFG)

227. Plaintiff repeats and realleges paragraphs ¶¶ 1 - 206 of this complaint and incorporate them by reference as though set forth in full herein.

228. Plaintiff is informed and believed, and thereupon allege that the acts of the Defendants in insuring sub-prime mortgage instruments and other financial instruments such as CDO's was done negligent and carelessly. In addition, due to the flawed methodology of rating such securities employed by the Credit Rating Agencies, it was negligent for the Defendants to insure both these high risk instruments while simultaneously insuring safe municipal bonds that relied on that insurance to maintain high ratings on their own bond issuances. Defendants owed a duty to Plaintiff Oakland not to act in a reckless and unreasonable manner. The

Defendants breached that duty and, as a result, caused the economic harm, injury and/or damage to Plaintiff that are hereinabove set forth.

229. As a direct and legal cause of the Defendants' wrongful acts and/or omissions, Plaintiff has suffered and will continue to suffer harm from the payment of insurance premiums for bond insurance that possesses no value, for higher interest rates caused by the credit downgrade of the Defendants and for any other refinancing costs endured due to the Defendants' misconduct.

WHEREFORE, Plaintiff prays for judgment against Defendants, and each of them, as set forth below.

SIXTH CAUSE OF ACTION

VIOLATIONS OF CALIFORNIA CARTWRIGHT ACT

(Against All Defendants)

230. Plaintiff repeats and realleges paragraphs ¶¶ 1 - 206 of this complaint and incorporate them by reference as though set forth in full herein.

231. The Defendants violated California Business and Professions Code section 16720, *et seq.* (the "Cartwright Act"), by forming one or more combinations to accomplish purposes prohibited by and contrary to the Cartwright Act. They engaged in an agreement, contract, combination, trust and/or conspiracy to create and maintain artificial conditions for the acquisition of municipal bond insurance.

232. The Defendants committed acts that constituted prohibited conduct under the Cartwright Act, including but not limited to making illegal agreements among themselves to reduce competition and to raise and establish the price and cost of municipal bond insurance. Defendants' conduct has unfairly and unlawfully increased the price and cost for the acquisition of municipal bond insurance in the State of California.

233. The California Supreme Court has specifically stated that a cause of action under the California Cartwright Act can be brought against the insurance industry in *Manufacturers Life Ins. Co. v. Superior Court* (1995) 10 Cal.4th 257.

234. As a direct result of the unlawful and unfair actions of the Defendants, Plaintiff suffered injury to its business and property. It has had to pay substantially more for the acquisition of municipal bond insurance than they would have absent Defendants' illegal and anti-competitive conspiracy. Moreover, it has had to endure higher interest rates and borrowing costs as a result of the improper conduct, as well as pay unnecessary fees and costs to the Defendants. These injuries have caused and will continue to cause damages to Plaintiff.

235. As a direct result of the acts of the Defendants, Plaintiff was required to file this action, resulting in ongoing attorneys' fees, costs, and other expenses for which it seeks recovery according to proof.

236. Pursuant to the Cartwright Act, Plaintiff is authorized to recover three times the damages it sustained plus interest and reasonable attorneys' fees, costs and expenses.

WHEREFORE, Plaintiff prays for judgment against Defendants, and each of them, as set forth below.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff prays that:

A. The Court adjudge and decree that the acts of the Defendants are illegal and unlawful and in violation of California state common and statutory law;

B. Judgment be entered against Defendants, jointly and severally, and in favor of Plaintiff for damages as allowed by law as determined to have been sustained by them;

C. Each of the Defendants, successors, assigns, parents, subsidiaries, affiliates and transferees, and their respective officers, directors, agents and

LAW OFFICES
COTCHETT, PITRE & McCARTHY

employees, and all other persons acting or claiming to act on behalf of Defendants or in concert with them, be permanently enjoined and restrained from, in any manner, directly or indirectly, continuing, maintaining or renewing the combinations, conspiracy, agreement, understanding or concert of action as alleged herein;

D. The Court award Plaintiff's attorneys' fees and costs, and pre-judgment and post-judgment interest as permitted by law; and

E. Because the aforementioned acts of the insurer Defendants, and each of them, were done maliciously, oppressively, and with intent to defraud, Plaintiff is entitled to punitive and exemplary damages in an amount to be shown according to proof at the time of trial.

F. The Court award Plaintiff such other and further relief as may be necessary and appropriate.

DATED: August 28, 2008. CITY OF OAKLAND

By: [signature]

JOHN A. RUSSO

DATED: August 28, 2008 COTCHETT, PITRE & McCARTHY

By: Joseph W. Cotchett

JOSEPH W. COTCHETT

LAW OFFICES COTCHETT, PITRE & McCARTHY

JURY TRIAL DEMAND

Plaintiff demands a trial by jury of all of the claims asserted in this Complaint so triable.

DATED: August 28, 2008

CITY OF OAKLAND

By:
JOHN A. RUSSO

DATED: August 18, 2008

COTCHETT, PITRE & McCARTHY

By:
JOSEPH W. COTCHETT

LAW OFFICES
COTCHETT, PITRE & McCARTHY

EXHIBIT B

PROSKAUER ROSE LLP
SCOTT P. COOPER, SBN 96905
KEITH BUTLER, SBN 215670
2049 Century Park East, 32nd Floor
Los Angeles, California 90067-3206
Telephone: (310) 557-2900
Facsimile: (310) 557-2193

Attorneys for Defendant
MBIA, INC.

SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SAN FRANCISCO

CITY OF OAKLAND, Plaintiff, v. AMBAC FINANCIAL GROUP INC.; MBIA, INC.; XL CAPITAL ASSURANCE INC.; FINANCIAL GUARANTY INSURANCE COMPANY; CIFG ASSURANCE NORTH AMERICA, INC.; JASON KISSANE; NEIL PACK; and Does 1 – 50, Defendants.	Case No. CGC-08-479241 [Assigned to the Honorable Arlene T. Borick – Dept. 212] **NOTICE TO STATE COURT OF DEFENDANTS' FILING OF NOTICE OF REMOVAL TO U.S. DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA** Action Filed: August 28, 2008

TO THE HONORABLE ARLENE T. BORICK, JUDGE OF THE SUPERIOR COURT OF THE STATE OF CALIFORNIA, FOR THE COUNTY OF SAN FRANCISCO:

PLEASE TAKE NOTICE that on September 22, 2008, a Notice of Removal of the above-entitled action pursuant to 28 U.S.C. § 1441(b) was filed in the United States District Court for the Northern District of California, bearing Case No. __________________. A true and correct copy of the Notice of Removal filed with the United States District Court for the Northern District of California is attached hereto as Exhibit A. Pursuant to 28 U.S.C. ¶ 1446(d), this Court "shall proceed no further unless and until the case is remanded."

DATED: September 22, 2008

PROSKAUER ROSE LLP
SCOTT P. COOPER
KEITH BUTLER

By: ________________________
Scott P. Cooper
Attorneys for Defendants
MBIA, INC.

EXHIBIT C

PROSKAUER ROSE LLP
SCOTT P. COOPER, SBN 96905
KEITH BUTLER, SBN 215670
2049 Century Park East, 32nd Floor
Los Angeles, California 90067-3206
Telephone: (310) 557-2900
Facsimile: (310) 557-2193

Attorneys for Defendant
MBIA, INC.

SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SAN FRANCISCO

CITY OF OAKLAND, Plaintiff, v. AMBAC FINANCIAL GROUP INC.; MBIA, INC.; XL CAPITAL ASSURANCE INC.; FINANCIAL GUARANTY INSURANCE COMPANY; CIFG ASSURANCE NORTH AMERICA, INC.; JASON KISSANE; NEIL PACK; and Does 1 – 50, Defendants.	Case No. CGC-08-479241 [Assigned to the Honorable Arlene T. Borick – Dept. 212] **NOTICE TO ADVERSE PARTY OF DEFENDANTS' FILING OF NOTICE OF REMOVAL TO U.S. DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA** Action Filed: August 28, 2008

TO PLAINTIFF CITY OF OAKLAND AND ITS ATTORNEYS OF RECORD:

PLEASE TAKE NOTICE that on September 22, 2008, a Notice of Removal of the above-entitled action pursuant to 28 U.S.C. § § 1441(b) was filed in the United States District Court for the Northern District of California, bearing Case No. __________________. A true and correct copy of the Notice of Removal filed with the United States District Court for the Northern District of California is attached hereto as Exhibit A.

DATED: September 22, 2008

PROSKAUER ROSE LLP
SCOTT P. COOPER
KEITH BUTLER

By: ______________________
Scott P. Cooper
Attorneys for Defendants
MBIA, INC.

EXHIBIT D

CONSENT TO REMOVAL

Defendant Ambac Financial Group, Inc. ("Ambac") hereby consents to removal of this action, *City of Oakland v. Ambac Financial Group Inc. et al.*, Docket No. CGC 08-479241, to federal court. This consent is given without waiving, and with a full reservation of, any and all rights, claims, and defenses of any nature whatsoever that Ambac may have, including but not limited to defenses related to service of process, jurisdiction, and venue.

Dated: New York, New York
September 22, 2008

Respectfully submitted,

PATTERSON BELKNAP WEBB & TYLER LLP
Robert P. LoBue
rplobue@pbwt.com
1133 Avenue of the Americas
New York, NY 10036-6710
(212) 336-2596
Fax: (212) 336-2395

-and-

MURPHY, PEARSON, BRADLEY & FEENEY

James A. Murphy
jmurphy@mpbf.com
88 Kearny Street, 10th Floor
San Francisco, Ca 94108
(415) 788-1900
Fax: (415) 393-8087

Attorneys for Defendant Ambac Financial Group, Inc.

CONSENT TO REMOVAL

Defendant XL Capital Assurance Inc. ("XLCA") hereby consents to removal of this action, *City of Oakland v. Ambac Financial Group Inc. et al.*, Docket No. CGC-08-479241, to federal court. This consent is given without waiving, and with a full reservation of, any and all rights, claims, and defenses of any nature whatsoever that CIFG may have, including but not limited to defenses related to service of process, jurisdiction, and venue.

Dated: Los Angeles, California
September 22, 2008

Respectfully submitted,
LOEB & LOEB LLP

Daniel G. Murphy (Bar No. 141006)
dmurphy@loeb.com
10100 Santa Monica Blvd.
Suite 2200
Los Angeles, California 90067
(310) 282-2000
Fax: (310) 282-2200

DEBEVOISE & PLIMPTON LLP

Mark P. Goodman
mpgoodman@debevoise.com
Elliot Greenfield
egreenfield@debevoise.com
919 Third Avenue
New York, New York 10022
(212) 909-6000
Fax: (212) 909-6836

Attorneys for Defendant XL Capital Assurance Inc.

CONSENT TO REMOVAL

Defendant Financial Guaranty Insurance Company ("FGIC") hereby consents to removal of this action, *City of Oakland v. Ambac Financial Group Inc. et al.*, Case No. CGC 08-479241, to federal court. This consent is given without waiving, and with a full reservation of, any and all rights, claims, and defenses of any nature whatsoever that FGIC may have, including but not limited to defenses related to service of process, jurisdiction, and venue.

Dated: September 22, 2008

Respectfully submitted,
RICHARDS KIBBE & ORBE LLP

David W.T. Daniels
ddaniels@rkollp.com
Portrait Building
701 8th Street, N.W.
Washington, DC 20001-3727
(202) 261-2960
Fax: (202) 261-2999

Brian S. Fraser
bfraser@rkollp.com
One World Financial Center
New York, New York 10281-1003
(212) 530-1800
Fax: (212) 530-1801

Attorneys for Defendant Financial Guaranty Insurance Company

CONSENT TO REMOVAL

Defendants CIFG Assurance North America, Inc. ("CIFG") and Neil Pack ("Pack") hereby consent to removal of this action, *City of Oakland v. Ambac Financial Group Inc. et al.*, Case No. CGC 08-479241, to federal court. This consent is given without waiving, and with a full reservation of, any and all rights, claims, and defenses of any nature whatsoever that CIFG and Pack may have, including but not limited to defenses related to service of process, jurisdiction, and venue.

Dated: New York, New York
September 22, 2008

Respectfully submitted,

CADWALADER, WICKERSHAM & TAFT LLP

By: ______________________

Name: Jonathan M. Hoff
jonathan.hoff@cwt.com
One World Financial Center
New York, New York 10281
Phone: (212) 504-6474
Fax: (212) 504-6666

Attorneys for defendants CIFG Assurance North America, Inc. and Neil Pack